INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statutes and regulations involved	2
Statement	2
Reasons for granting the writ	8
Conclusion	17
Appendix A	19
Appendix B	63
Appendix C	73
Appendix D	75
Appendix E	77
Appendix F	81
Appendix G	85

CITATIONS

Cases:	
Commissioner v. *Tellier*, 383 U.S. 687	11
Falstaff Beer, Inc. v. *Commissioner*, 322 F. 2d 744	15
First Federal S. & L. Ass'n of St. Joseph v. *United States*, 288 F. Supp. 477	9
Golsen v. *Commissioner*, 54 T.C. 742	9
M.F.A. Central Cooperative v. *Bookwalter*, 70–1 USTC, par. 9484	16
Mississippi Chemical Corp. v. *United States*, 69–1 USTC, par. 9266, appeal pending, C.A. 5, No. 28271	16
Penn Yan Agway Cooperative, Inc. v. *United States*, 417 F. 2d 1372	16
Security Mills Co. v. *Commissioner*, 321 U.S. 281	13
Washington Fed. S. & L. Ass'n of Miami Beach v. *United States*, 304 F. Supp. 1072, appeal pending, C.A. 5, No. 29189	9
Welch v. *Helvering*, 290 U.S. 111	15
Wichita State Bank v. *Commissioner*, 69 F. 2d 595	10, 15
Woolrich Woolen Mills v. *United States*, 289 F. 2d 444	15

400-943—70——1

Statutes:

Act of December 23, 1969, P.L. 91–151, 83 Stat. 371, Sec. 6 — Page 5

Farm Credit Act of 1933, c. 98, 48 Stat. 257, Sec. 42(a)(3), as amended, c. 785, 69 Stat. 655, Sec. 101, 12 U.S.C. 1134d(a)(3) — 16

Federal Home Loan Bank Act, c. 522, 47 Stat. 727, as amended, 12 U.S.C. (1958 ed.) 1421, *et seq.* — 2
- Sec. 6(c) — 4, 81
- Sec. 6(*l*) — 4, 82

Federal Home Loan Bank Act, c. 522, 47 Stat. 727, as amended, Sec. 6(c)(1), 12 U.S.C. (1964 ed.) 1426(c)(1) — 4, 85

Internal Revenue Code of 1954 (26 U.S.C.):
- Sec. 162(a) — 2, 3, 7, 77
- Sec. 1311(b)(2) — 9, 10
- Sec. 1312(4) — 9, 10

National Housing Act, c. 847, 48 Stat. 1246, Title IV, 12 U.S.C. (1958 ed.) 1724, *et seq.* — 2
- Sec. 402 — 85
- Sec. 403 — 2
- Sec. 404(a) — 3, 82–83
- Sec. 404(b) — 83

National Housing Act, c. 847, 48 Stat. 1246, Title IV, as amended by Secs. 3, 4, 5, and 6 of the Act of September 8, 1961, P.L. 87–210, 75 Stat. 482, 12 U.S.C. 1724, *et seq.* — 2
- Sec. 404 — 3, 5
- Sec. 404(a) — 3, 4, 86
- Sec. 404(b) — 3, 5, 6, 7, 87
- Sec. 404(c) — 87
- Sec. 404(d) — 2, 3, 4, 5, 7, 8, 9, 11, 12, 13, 14, 88
- Sec. 404(e) — 4, 6, 89
- Sec. 404(f) — 6, 89–90
- Sec. 404(g) — 5, 91–92

Miscellaneous:

H. Rep. No. 823, 87th Cong., 1st Sess. — 4, 12

Rev. Rul. 66–49, 1966–1 Cum. Bull. 36 — 6

S. Rep. No. 778, 87th Cong., 1st Sess. — 12

Treasury Regulations on Income Tax (26 C.F.R.)
- Sec. 1.461–1(a) — 11, 77–79

In the Supreme Court of the United States

OCTOBER TERM, 1970

No.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

LINCOLN SAVINGS AND LOAN ASSOCIATION

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Ninth Circuit in this case.

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (Appendix A, *infra,* pp. 19–62), are reported at 51 T.C. 82. The opinion of the court of appeals (Appendix B, *infra,* pp. 63–72) is reported at 422 F. 2d 90.

JURISDICTION

The judgment of the court of appeals was entered on February 3, 1970 (Appendix C, *infra,* p. 73).

The Commissioner's timely filed petition for rehearing *en banc* was denied on March 18, 1970 (Appendix D, *infra*, p. 75). By order dated June 12, 1970, Mr. Justice Douglas extended the time for filing a petition for a writ of certiorari to and including August 15, 1970. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether a payment by a savings and loan association to the Federal Savings and Loan Insurance Corporation pursuant to Section 404(d) of the National Housing Act is deductible at the time of payment as an ordinary and necessary business expense under Section 162(a) of the Internal Revenue Code.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of the Internal Revenue Code of 1954 and the Treasury Regulations on Income Tax (1954 Code) are set forth in Appendix E, *infra*, pp. 77–79. The pertinent provisions of the Federal Home Loan Bank Act and the National Housing Act, before and after their amendment in 1961, are set forth in Appendices F and G, *infra*, pp. 81–92.

STATEMENT

Respondent, a state-chartered (California) savings and loan association, is a member of the Federal Home Loan Bank of San Francisco.[1] Respondent insures its

[1] That bank and other federal home loan banks were established under authority of the Federal Home Loan Bank Act, c. 522, 47 Stat. 727 (12 U.S.C. 1421, *et seq.*).

depositors' accounts through the Federal Savings and Loan Insurance Corporation ("FSLIC").[2]

To maintain this insurance in force, respondent is required to pay to FSLIC regular annual insurance premiums. See Section 404(b) of the National Housing Act (Appendix G, *infra*, p. 87).[3] Such premiums are deductible under Section 162(a) of the Internal Revenue Code (Appendix E, *infra*, p. 77). In addition to the "Section 404(b)" payments, respondent has been required since 1962 to make additional annual payments "in the nature of * * * prepayment[s] with respect to future premiums." See Section 404(d) of

---

[2] FSLIC, which was created under Title IV of the National Housing Act, c. 847, 48 Stat. 1246 (12 U.S.C. 1724, *et seq.*), operates under the direction of the Federal Home Loan Bank Board. It is required by statute to insure the accounts of all federal savings and loan associations and is permitted to insure the accounts of qualified state-chartered savings and loan associations. Section 403 of the National Housing Act (12 U.S.C. 1726).

[3] Prior to 1962, each institution insured by FSLIC was required to pay a regular annual premium for insurance on depositors' accounts of $\frac{1}{12}$ of one percent of the total amount of its savings accounts and creditor obligations, until such time as FSLIC's reserve for losses equalled or exceeded five percent of the insured accounts and creditor obligations of all insured institutions, and thereafter to make such additional payments as might be required to keep the reserve at this level. Section 404(a) of the National Housing Act (Appendix F, *infra*, pp. 82–83). In 1961, Congress amended Section 404 of Title IV of the National Housing Act (12 U.S.C. 1727), effective January 1, 1962. Act of September 8, 1961, P.L. 87-210, 75 Stat. 482. As amended, Section 404(b) (Appendix G, *infra*, p. 87) continued to require regular annual premiums at the same $\frac{1}{12}$ of one percent rate, but provided that the obligation to pay such premiums should continue only until such time as the general reserve (now called the "Primary Reserve") reached two percent of total insured savings and creditor obligations of insured institutions.

the National Housing Act (Appendix G, *infra*, p. 88).[4] It is the tax character of the "Section 404(d)" payments—whether they are capital expenditures or deductible business expenses—that is here in dispute.

Section 404(b) payments received by FSLIC are part of its gross income, are available to meet its current expenses and losses, and, to the extent not so used, are transferred to FSLIC's "Primary Reserve," to be used, if necessary, to meet future years' losses. Section 404(d) payments, on the other hand, are not considered part of FSLIC's regular income but are transferred directly to FSLIC's "Secondary Reserve," as provided by Section 404(a) of the National Housing Act (Appendix G, *infra*, pp. 86–87). This Reserve is available to FSLIC only to meet its losses and only to the extent that other available accounts are insufficient to meet such losses. Section 404(e) (Appendix G, *infra*, p. 89). The financial statements of FSLIC reveal no year in

[4] Prior to 1962, additional annual payments were not required. Under Section 404(d) of the National Housing Act, as amended by the Act of September 8, 1961 (see n. 3, *supra*), an insured institution must make such payments in an amount equal to two percent of any net increase in its insured accounts during the preceding year, reduced by its obligation, if any, as of the end of such year to purchase capital stock in its federal home loan bank. Pursuant to Section 6(c)(1) of the Federal Home Loan Bank Act (12 U.S.C. 1246) (Appendix G, *infra*, p. 85), which was also amended by the Act of September 8, 1961, a member institution in a federal home loan bank must own capital stock in that bank in an amount at least equal to one percent of the member's outstanding unpaid loan principal. Before 1962, two percent ownership was required. See Section 6 (c) and (l) of the Federal Home Loan Bank Act (Appendix F, *infra*, pp. 81–82). It was contemplated in the Act of September 8, 1961, that the newly imposed Section 404(d) "prepayment requirement would be approximately offset" by the reduction in required outlays for federal home loan bank stock. H. Rep. No. 823, 87th Cong., 1st Sess., p. 2.

which its net insurance losses exceeded even its investment income from the Primary Reserve.

An insured institution has no interest in FSLIC's Primary Reserve. It does have an interest, however, in the Secondary Reserve, which is reflected in the institution's separate account maintained by FSLIC (Section 404(e)), and which is used to pay the institution's regular insurance premiums in future years after the total of the Primary and Secondary Reserves reaches certain levels as hereinafter described. The insured institution's separate account includes a pro rata share of the earnings allocated to the Secondary Reserve "at a rate equal to the average annual rate of return to the Corporation * * * on the investments held by the Corporation in obligations of, or guaranteed as to principal and interest by, the United States." Section 404(e).

When, at the close of any calendar year, the aggregate of the Primary Reserve and the Secondary Reserve equals or exceeds two percent of all insured accounts and creditor obligations of all insured institutions, the obligation of insured institutions to make Section 404(d) payments is to be suspended until such aggregate amount falls below 1¾ percent of all insured accounts and credit obligations; the obligation is to be terminated when the amount in the Primary Reserve alone equals or exceeds two percent of all insured accounts and creditor obligations of all insured institutions.[5] In any year in which the obliga-

[5] Section 404 of the National Housing Act was amended by P.L. 91-151, 83 Stat. 371, enacted on December 23, 1969, to provide that only insured accounts (and not creditor obligations) are to be taken into account in determining the required two percent levels in connection with both the suspension and termination of Section 404(d) payments.

tion to make Section 404(d) payments is suspended, the pro rata share of each insured institution in the Secondary Reserve will be used, to the extent needed and available, to make Section 404(b) payments. Section 404(g) (Appendix G, *infra*, pp. 91-92).

According to FSLIC projections made in 1961, the aggregate of the Primary Reserve and the Secondary Reserve would equal or exceed two percent of all insured accounts and creditor obligations of all insured institutions by 1970, and the Primary Reserve itself would reach the two percent level in 1995.[6]

Although an insured institution's "right, title or interest" in the Secondary Reserve is not generally transferable or assignable, FSLIC has authority to provide for the transfer of an institution's pro rata share "in cases of merger or consolidation, transfer of bulk assets * * * and similar transactions." Section 404(e). Moreover, an insured institution is entitled to a cash refund of its pro rata share in the event that (1) its status as an insured institution is terminated, (2) a conservator, receiver, or other legal custodian is

[6] The FSLIC estimates set out in Appendix A, *infra*, p. 33, show that Section 404(d) payments would be required to be made from 1962 through 1970, and from 1976 through 1979, and that no such payments would be required from 1971 through 1975, and from 1980 through 1995. Because of the 1969 amendment (n. 5, *supra*), the combined Primary and Secondary Reserves reached the two percent suspension level in 1969, rather than in 1970 as originally projected. Beginning this year, the Secondary Reserves are being used to meet the insured institutions' obligations for Section 404(b) payments. FSLIC has not yet prepared a new projection based on the 1969 amendment, but there is no reason to expect that the new estimates will vary significantly from the previous estimates.

appointed for the purpose of liquidating the assets of the institution, (3) FSLIC determines that such institution has gone into voluntary liquidation, or (4) the Primary Reserve alone reaches two percent of the total amount of all insured accounts and creditor obligations of all insured institutions. Section 404(f) and (g) (Appendix G, *infra*, pp. 89–92).

Pursuant to regulations issued by the California Savings and Loan Commissioner and by the Federal Home Loan Bank Board, respondent reported its interest in FSLIC's Secondary Reserve as an asset on its balance sheet and on its published financial statement, and treated the interest earned on its pro rata share of the Secondary Reserve as income.[7] The firm of Peat, Marwick, Mitchell & Co., certified public accountants, stated in their audit of respondent's financial statements for the years 1962 through 1966 that respondent's financial position had been presented fairly therein, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

On its federal income tax return for 1963, respondent deducted both its Section 404(b) and Section 404(d) payments as ordinary and necessary business expenses under Section 162(a) of the Internal Revenue Code (Appendix E, *infra*, p. 77). The Commissioner allowed the former, but disallowed the

[7] Such interest, which is added to respondent's pro rata share of the Secondary Reserve, is not taxed in the year received but in the year in which it is utilized to pay respondent's regular annual FSLIC insurance premium. Rev. Rul. 66–49, 1966–1 Cum. Bull. 36.

latter. In a unanimous reviewed opinion, the Tax Court agreed with the Commissioner. It held that the Section 404(d) payments were nondeductible capital expenditures, and that such payments could be deducted only when used to pay regular insurance premiums or to meet actual losses of FSLIC. Appendix A, *infra*, pp. 19–62. A divided court of appeals reversed and held the Section 404(d) payments to be currently deductible business expenses. Appendix B, *infra*, pp. 63–72.

REASONS FOR GRANTING THE WRIT

1. The question presented in this case is of substantial fiscal and administrative significance. The decision below affects the tax liabilities of all of the approximately 4,500 savings and loan associations which have insured their depositors' accounts with FSLIC in the 1960's. As of June 10, 1970, 2,487 such associations had on file in the various district directors' offices claims relating to the treatment of Section 404(d) payments totalling more than $72.5 million of tax. Of these cases, 371, involving approximately $19.5 million, are pending administratively within the Ninth Circuit and would be governed directly by the decision below. Although an estimated 2,000 savings and loan associations have not filed claims, they are free to do so to the extent that the statute of limitations has not closed prior years' returns.

Even viewing the question here as one of the proper timing of deductions, the revenues involved are substantial. Statutory interest on the 2,487 claims referred to above will amount to slightly less than

$22 million as of August 15, 1970. This does not take account of additional interest liability which the government may incur if additional claims are filed for prior years. Nor does it reflect the fact that savings and loan associations will be making Section 404(d) payments intermittently until 1979 (see n. 6, *supra*), and that under the court of appeals' decision, the associations will be entitled to deduct these payments currently, rather than at the later time when the payments are applied to discharge their Primary Reserve obligations. The earlier allowance of deductions would result in a substantial loss to the government, because it would be deprived of the use of tax revenue during the interim periods.

Apart from the fiscal implications of the Ninth Circuit's decision, that decision threatens to create serious administrative difficulties. As long as the Commissioner and the Tax Court follow the position they have taken here,[8] and unless and until this Court or every circuit court decides this matter adversely to the government,[9] savings and loan institutions which have deducted Section 404(d) payments currently will be forced to claim deductions for the

[8] Under its recently formulated policy, the Tax Court will accept the Ninth Circuit's decision only in cases in which appellate review lies to the Ninth Circuit. In other cases, it will follow its unanimous reviewed decision in this case. See *Golsen* v. *Commissioner*, 54 T.C. 742, 756–758.

[9] This is a case of first appellate impression. The issue raised was decided adversely to the government in *First Federal S. & L. Ass'n of St. Joseph* v. *United States*, 288 F. Supp. 477 (W.D. Mo.), and in *Washington Fed. S. & L. Ass'n of Miami Beach* v. *United States*, 304 F. Supp. 1072 (S.D. Fla.), now pending on the government's appeal in the Fifth Circuit (No. 29189).

same payments when these payments are later used to discharge regular insurance premium obligations. If they fail to do so, and if the statute of limitations runs on the later years while the earlier years are not closed by the statute of limitations or by *res judicata,* such institutions might be precluded from obtaining any deductions for the disputed Section 404(d) payments, in the event the Commissioner ultimately prevails. Savings and loan associations thus will have no choice but to take inconsistent positions in order to be assured of at least one deduction,[10] and the Commissioner likewise will have to disallow deductions in both taxable years in order to protect the revenues.

Acceptance by the Commissioner of the rule adopted by the Ninth Circuit would not solve the administrative dilemma which this case poses. For example, if there is a significant increase in the tax rate imposed on savings and loan associations, one or more of the 2,000 associations that have thus far followed the rule prescribed by the Commissioner may decide that they would prefer to take their deductions

[10] Sections 1311(b)(2)(B) and 1312(4) of the Code lift the bar of the statute of limitations in certain cases where a deduction disallowed in one taxable year is allowable in another taxable year that otherwise would be closed by the statute. This relief, however, apparently is available only in a case in which the deduction is erroneously claimed by the taxpayer for a taxable year subsequent to the year in which it is properly allowable, not the converse situation presented here. At all events, this matter has not been authoritatively settled, and savings and loan associations could not safely avoid filing protective claims for the later years in reliance on Sections 1311(b)(2)(B) and 1312(4).

in later taxable years when the tax rate is higher, rather than in the earlier years when the rate was lower. Or, a number of these associations may choose for some other reason to continue to report as they have in the past.[11]

This is, then, the rare case in which a definitive resolution of the issue—one way or the other—is almost as important as the outcome. Such a resolution can be provided only through review by this Court at this time.

2. As for the merits, little can be added in support of the government's position to what Judge Raum has said in writing for a unanimous Tax Court. The Tax Court's decision is based on the fundamental tax principle that a cost that results in the creation of an asset with a useful life extending beyond the taxable year may not be deducted in the current taxable year. Treasury Regulations on Income Tax (1954 Code), Section 1.461–1(a), Appendix E, *infra*, pp. 77–79. See *Commissioner* v. *Tellier*, 383 U.S. 687. We think it is clear that respondent's interest in the Secondary Reserve constituted such an asset—a capi-

[11] Precisely this sequence of events occurred in connection with payments made by Texas State banks to the Texas State Depositor's Guaranty Fund in the 1920's. As recounted in detail by the Tax Court (Appendix A, *infra*, pp. 58–60), the Bureau of Internal Revenue first took the position that the payments were deductible when made, but then changed its position. When the new position was rejected by the Board of Tax Appeals, the Bureau reverted to its original position, only to have that position rejected by the Fifth Circuit in a case in which the taxpayer preferred the rule which the Commissioner now urges. See *Wichita State Bank & T. Co.* v. *Commissioner*, 69 F. 2d 595.

tal investment in FSLIC. Perhaps it could be called a forced loan, but it is a loan, and was treated as an asset. Its benefit will inure to respondent, in one form or another, at a future time.

Although respondent had to make Section 404(d) payments in order to maintain its deposits in an insured status, the Section 404(d) payments, unlike the ordinary insurance premiums, are not consumed during the taxable years in which they are made. On the contrary, respondent retains a beneficial interest in the Secondary Reserve and in the investment income earned thereon, which is credited to respondent's account. The payments and income are returnable to respondent at such times (beginning in 1970 and intermittently thereafter) as they are used to discharge respondent's obligation to pay ordinary annual insurance premiums. If not so used, they are returnable in the event of respondent's liquidation, at the time of its withdrawal from the FSLIC system, or when the Primary Reserve alone exceeds the required two percent level. And, respondent's interest in the Secondary Reserve is transferrable to another association in a consolidation, merger, or bulk sale of its assets.

Further evidence that respondent's interest in the Secondary Reserve is a capital investment is provided by the facts that FSLIC is required by law to segregate that reserve from its other assets, and may use it to meet current losses only if its other assets are insufficient for that purpose. These are the classic characteristics of a capital account, for as Judge Raum pointed out (Appendix A, *infra*, p. 52), "what,

after all, is the capital account of any corporation if not a 'Secondary Reserve,' a pool of capital available to creditors in the event that the corporation's current income and retained earnings are not sufficient to satisfy their claims?" [12]

That respondent's liability for the Section 404(d) payment presently in dispute was fixed and determinable as of the end of 1963, and that, except in limited circumstances, respondent's interest in the Secondary Reserve could not be liquidated, cannot alter the conclusion that respondent acquired something of value in the nature of a capital asset. A capital cost is not converted into a deductible expense merely because the liability for the cost is absolute when it is incurred,[13] or because the cost may not easily be recovered through immediate con-

[12] Additional support for the Tax Court's conclusion may be found in the legislative history of the National Housing Act. The Section 404(d) payment requirement was instituted at the same time that Congress lowered the requirement for purchase of federal home loan bank stock by institutions such as respondent, observing that the "prepayment requirement would be approximately offset" by the resulting reduction in outlays for stock. H. Rep. No. 823, 87th Cong., 1st Sess., p. 2; S. Rep. No. 778, 87th Cong., 1st Sess., pp. 1–2. It is thus clear that the intended function of the Section 404(d) payment requirement was to create a temporary pool of capital in the form of a Secondary Reserve, to replace the permanent pool of capital represented by the federal home loan bank stock.

[13] The court of appeals' reliance on *Security Mills Co.* v. *Commissioner*, 321 U.S. 281, is misplaced. That case enunciates the general rule that a business expense deduction is allowable in the year in which it is paid or accrued, depending on the taxpayer's method of accounting. It has no bearing on the question whether a particular cost is an ordinary expense or a capital expenditure.

version into cash or other assets. This is typically true of a loan with a maturity in the future. Nor is it of moment that there was a remote possibility—if FSLIC's other assets were depleted—that the Secondary Reserve would be used immediately to discharge FSLIC's liabilities. In that event, respondent would be entitled to a current deduction. But apart from this, it is axiomatic that the cost of a capital or depreciable asset may not be deducted at the time of acquisition on the ground, for example, that there is an undeterminable possibility of its immediate loss.

The error of the Ninth Circuit's opinion is shown most clearly by its discussion (Appendix B, *infra*, pp. 67–70) of tax accounting concepts. Its conclusion that the Section 404(d) payments are a "recurring annual expense" (Appendix B, *infra*, p. 71) is incorrect as pointed out in Judge Hufstedler's dissenting opinion (*id.*, pp. 71–72). Based on FSLIC's 1961 projections (see n. 6, *supra*), such payments would be required to be made in only 13 of the 34 years between 1962 and 1995.

It is respondent's regular insurance premiums, *not* its Section 404(d) payments, that are its "recurring annual expense." In attempting to match respondent's costs and revenues in accordance with accounting principles, the Ninth Circuit has formulated a rule that has exactly the opposite effect. For, under its decision, there will be some years in which savings and loan associations will receive two deductions, and others in which they will be entitled to no deduction at all, even though they will have the benefit of FSLIC insurance in all taxable years. It is not sur-

prising, therefore, that Peat, Marwick & Mitchell certified respondent's financial statements, in which the Section 404(d) payments were not deducted when paid, as being in accord with generally accepted accounting principles.

3. In holding that respondent's Section 404(d) payment for 1963 was deductible when paid, the Ninth Circuit majority was influenced by its assumption that, since depositors were likely to close their accounts if respondent cancelled its FSLIC insurance, the payment "has to be made to stay in business" (Appendix B, *infra*, p. 71). The fact that a taxpayer's outlay is coerced by force of law or economic circumstances should not alter the nature of the inquiry, which is whether the outlay represents an expense to be offset against income for the year in which it is paid or the creation of a capital asset. *Welch* v. *Helvering*, 290 U.S. 111, 113; *Woolrich Woolen Mills* v. *United States*, 289 F. 2d 444, 448 (C.A. 3); *Falstaff Beer, Inc.* v. *Commissioner*, 322 F. 2d 744, 745 (C.A. 5). Indeed, in *Wichita State Bank & T. Co.* v. *Commissioner*, 69 F. 2d 595 (C.A. 5), the Fifth Circuit held that payments by a bank into a depositors' guarantee fund could not be deducted when made, even though such payments were compulsory under Texas law if the bank did not otherwise insure its depositors' accounts. In that case, as in this one, each participating bank's pro rata share was returnable upon its withdrawal from the fund or upon its liquidation. As concluded by the Fifth Circuit (p. 596):

> That fund is not intended to be lost or consumed, but is to stand as a reservoir drawn on to provide prompt payment to depositors, but

> to be at once replenished by the special assessments. It is analogous to the capital of an insurance company. Each bank owns its pro rata part in it, which it ought ultimately to get back. * * * We think the contributions to the $5,000,000 Guaranty Fund, while made annually instead of in a lump sum, were essentially capital investments and ought to be dealt with as such. * * *

That portion of the majority opinion below emphasizing the element of economic compulsion conflicts in principle with the conclusion of the Court of Appeals for the Eighth Circuit in *M.F.A. Central Cooperative* v. *Bookwalter,* 70–1 USTC, par. 9484. It was there held that the taxpayer was not entitled to a business or interest expense deduction for a part of the cost of Class C stock in the Bank for Cooperatives, which was purchased pursuant to Section 42(a)(3) of the Farm Credit Act of 1933.[14] The deduction was disallowed even though the taxpayer was required by law to purchase Class C stock in order to borrow from the cooperative. Squarely in conflict with *M.F.A. Cooperative* is *Penn Yan Agway Cooperative, Inc.* v. *United States,* 417 F. 2d 1372 (Ct. Cl.), where the Court of Claims, like the Ninth Circuit below, relied on the economic compulsion aspect in concluding that a portion of the cost of the Class C stock was deductible as interest.[15] While this case

---

[14] C. 98, 48 Stat. 257, 264, as amended by the Farm Credit Act of 1955, c. 785, 69 Stat. 655, 656, Sec. 101, 12 U.S.C. 1134d(a)(3).

[15] The same issue is presented in *Mississippi Chemical Corp.* v. *United States*, 69–1 USTC, par. 9266 (S.D. Miss.), now pending on the government's appeal in the Fifth Circuit (No. 28271).

and the cooperative cases arise in different contexts, the question, insofar as the significance of economic compulsion is concerned, is identical, and is one that warrants present consideration by this Court.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

ERWIN N. GRISWOLD,
Solicitor General.

JOHNNIE M. WALTERS,
Assistant Attorney General.

MATTHEW J. ZINN,
Assistant to the Solicitor General.

GILBERT E. ANDREWS,
DAVID ENGLISH CARMACK,
Attorneys.

AUGUST 1970.

APPENDIX A

51 T.C. No. 10

Tax Court of the United States

LINCOLN SAVINGS AND LOAN ASSOCIATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 325–67—Filed October 21, 1968

Petitioner, a California savings and loan association, insures the accounts of its depositors with the Federal Savings and Loan Insurance Corporation (FSLIC). It pays regular annual premiums for such insurance coverage, which are deductible. Such premiums are part of FSLIC's gross income, available to meet all current expenses and losses, and to the extent not so used are transferred to FSLIC's "Primary Reserve" to meet losses of future years. Since 1962, petitioner has also been required to make additional annual payments "in the nature of * * * prepayment[s] with respect to future premiums." Such "prepayments" immediately become part of the FSLIC's "Secondary Reserve," which is available to a limited extent to meet future losses in the event of depletion of all other resources of the FSLIC. Although petitioner has no interest in the Primary Reserve, it has a pro rata interest in the Secondary Reserve. That interest is reflected in an account which is rendered to it annually by the FSLIC showing the amount of the "prepayments" made by petitioner together with an annual "return" computed upon the

balance in the account at the end of each year. The balance in such account is to be used to discharge petitioner's obligation to pay its regular insurance premiums in future years after the total of FSLIC's Primary Reserve and Secondary Reserve reaches a certain level, but petitioner may transfer its account (its pro rata interest in the Secondary Reserve) to another insured institution in the event of merger, consolidation or bulk sale, and may recover any unused balance in its account in cash if it terminates insurance with the FSLIC or liquidates. Petitioner's pro rata share of the Secondary Reserve appears on its financial statements and the consolidated statements of its parent as an asset, and both State and Federal regulatory agencies require that the "prepayments" be capitalized and not expensed until used to pay premiums or cover losses. *Held,* the "prepayments" are also capital expenditures for Federal income tax purposes, deductible only in the years and to the extent used to discharge petitioner's obligation to pay regular insurance premiums or to meet actual losses of the FSLIC.

Adam Y. Bennion, A. Calder Mackay and *Richard N. Mackay,* for the petitioner.

James A. Thomas, for the respondent.

The Commissioner determined a deficiency in petitioner's income tax of $461,454.38 for the year 1963. Petitioner disputes so much of that deficiency as is based upon the Commissioner's disallowance of a deduction in the amount of $882,636.86, which petitioner claimed as a "Federal Insurance Premium" expense in that year. Petitioner paid this amount to the Federal Savings and Loan Insurance Corporation in 1963, as well as its regular annual insurance premium for that year, as it was required to do by 12 U.S.C. sec.

1727(d), which section characterized the payment as an "additional premium in the nature of a prepayment with respect to future premiums." The issue for decision is whether such payment was an ordinary and necessary expense of petitioner's business in 1963, or whether it was a capital expenditure deductible, if at all, only when actually used to discharge petitioner's obligation to pay regular annual insurance premiums or to meet insurance losses of the Federal Savings and Loan Insurance Corporation.

FINDINGS OF FACT

Some of the facts have been stipulated and, as stipulated, are incorporated herein by this reference together with accompanying exhibits.

Lincoln Savings and Loan Association (hereinafter sometimes referred to as "petitioner") is a corporation organized under the laws of the State of California, incorporated on February 6, 1925. Its name, originally Lincoln Building & Loan Assoication, was changed on August 5, 1943 to Lincoln Savings and Loan Assoication. At the date of the filing of the petition in this case, petitioner's principal office was located at 630 West Sixth Street, Los Angeles, California. It filed its tax returns for the calendar years 1962, 1963 and 1964 on the cash receipts and disbursements basis of accounting with the district director of internal revenue, Los Angeles, California.

All of petitioner's outstanding stock (consisting of 2,500 shares with a par value of $100 per share) has been owned since 1964 by First Lincoln Financial Corporation, which is a corporation organized under the laws of the State of California with its principal office in Los Angeles, California. During 1962 and 1963, First Lincoln Financial Corporation owned

98.88 percent of petitioner's outstanding stock. On December 31, 1963, First Lincoln Financial Corporation had 1,402,654 shares of stock outstanding, without par value, owned by approximately 2,800 shareholders. Its stock is traded over-the-counter.

Petitioner was licensed as a savings and loan association by the Savings and Loan Commissioner of the State of California on February 6, 1925, and since that date has been and remains a licensed savings and loan association under the laws of the State of California, transacting business in the Los Angeles area. As such, it is regulated by Division II of the California Financial Code (West's Annotated California Codes, Financial Code, Section 5000, *et seq.*) and by regulations of the California Savings and Loan Commissioner, which law and regulations are incorporated herein by reference.

Petitioner is a member of the Federal Home Loan Bank of San Francisco, one of twelve regional district banks established and supervised by the Federal Home Loan Bank Board (hereinafter sometimes referred to as the FHLB Board) under authority of the Federal Home Loan Bank Act of 1932. See 12 U.S.C. sec. 1423. These banks provide additional liquidity and funds for mortgage lending by making advances to member institutions as needed to meet unusual or heavy withdrawal and credit demands. As a condition of membership, each member institution is required to purchase capital stock in its bank equal to one percent of its outstanding "unpaid loan principal," and to invest in such amounts of stock thereafter as is necessary to maintain this percentage. 12 U.S.C. sec. 1426(c). Prior to 1962 the statutory level was two percent but thereafter, as part of a comprehensive legislative plan calling for certain additional

payments by "insured institutions" to the Federal Savings and Loan Insurance Corporation, as hereinafter set forth, the level was reduced to one percent.

Since 1938, petitioner has been an "insured institution" of the Federal Savings and Loan Insurance Corporation (hereinafter sometimes referred to as the FSLIC), a corporation created by the laws of the United States under Title IV of the National Housing Act of 1934, 12 U.S.C. sec. 1724 *et seq.*, and operated under the direction of the FHLB Board, which is required by statute to insure the accounts of all Federal savings and loan associations, and is permitted to insure the accounts of qualified state-chartered savings and loan associations, such as petitioner. 12 U.S.C. sec. 1726. Members of the Federal Home Loan Bank system are not required to insure the savings accounts of their depositors with the FSLIC, unless they are also Federally-chartered savings and loan associations. Similarly, except for Federal savings and loan associations, any insured institution of the FSLIC may voluntarily terminate such insurance, provided adequate notice is given to depositors and other technical requirements are met; the FHLB Board may, however, direct an involuntary termination of the insurance of any insured institution under certain conditions, though it has done so only once in the history of the FSLIC. Petitioner placed a great deal of emphasis in its advertising upon the fact that it was a Federally insured institution and, in the opinion of its management, loss of its insured status with the FSLIC would cause a mass withdrawal of savings by its depositors.

Prior to January 1, 1962, each insured institution was required by section 1727(a) of Title 12 of the United States Code (sec. 404(a) of the National

Housing Act) to pay an annual insurance premium to the FSLIC equal to $\frac{1}{12}$ of 1 percent of the total amount of its savings accounts and creditor obligations. Such premiums were to be continued until the FSLIC's reserve for losses equalled or exceeded five percent of the insured accounts and creditor obligations of all insured institutions (its potential liabilities), and at such intervals thereafter as might be required to keep the reserve fund at this level. Public Law 87–210, 75 Stat. 482, pertinent parts of which are set forth in the margin,[1] amended section 1727 of Title 12 of the United States Code, effective January 1, 1962, to its present form. An annual insurance premium at the rate of $\frac{1}{12}$ of one percent is still required of all insured institutions (provision for which is now made in section 1727(b)(1)), though

---

[1] Public Law 87–210 amended section 404 of the National Housing Act (12 U.S.C. sec. 1727) to read as follows:

Sec. 1727. Primary and secondary reserves.

(a) Establishment.

The Corporation shall establish a Primary Reserve which shall be the general reserve of the Corporation and a Secondary Reserve to which shall be credited the amounts of the prepayments made by insured institutions pursuant to subsection (d) of this section and the credits made pursuant to the first sentence of subsection (e) of this section.

(b) Premiums for insurance; amount; time of payment; waiver, rules and regulations

(1) Each institution whose application for insurance is approved by the Corporation shall pay to the Corporation, in such manner as it shall prescribe, a premium for such insurance equal to one-twelfth of 1 per centum of the total amount of all accounts of the insured members of such institution plus any creditor obligations of such institution. Such premium shall be paid at the time the certificate is issued by the Corporation under section 1726 of this title, and thereafter annually, except that under regulations prescribed by the Corporation such premium may be paid semiannually.

(2) If, at the close of any December 31, the Primary Re-

Footnote continued on next page.

the point at which such premiums are to cease and the level at which the FSLIC's general reserve is to be maintained has been lowered from five to two percent of total insured savings and creditor obligations of insured institutions. (Section 1727(b)(2)). But insured institutions are now required under the amended provisions of section 1727, to make further

Footnote 1—Continued

serve equals or exceeds 2 per centum of the total amount of all accounts of insured members and creditor obligations of all insured institutions as of such close, no premium under paragraph (1) of this subsection shall be payable by any insured institution with respect to its premium year beginning during the year commencing on May 1 next succeeding such December 31, except that the foregoing provisions of this sentence shall not be applicable to any insured institution with respect to any of the twenty premium years beginning with the premium year commencing with the date on which such certificate is issued.

(3) The Corporation is authorized to prescribe such rules and regulations as it may determine to be necessary or appropriate to accomplish the purposes and provisions of this subsection.

* * * * *

(d) Prepayments; amount; credit to Secondary Reserve; amount for newly insured institutions.

Each insured institution, except as otherwise provided in this section, shall annually pay to the Corporation, at such time and in such manner as the Corporation shall by regulations or otherwise prescribe, an additional premium in the nature of a prepayment with respect to future premiums of such institution under subsection (b) of this section equal to 2 per centum of the net increase in all accounts of its insured members during the next preceding calendar year, less an amount equal to any requirement, as of the end of such calendar year, for the purchase of stock of the Federal Home Loan Bank of which such institution is a member, calculated in accordance with the provisions of subsection (c) of section 1426 of this title and without regard to any net increase during such calendar year in its holdings of such stock, and such prepayments shall be credited to the Secondary Reserve * * *.

Footnote continued on next page.

annual payments to the FSLIC (provided for in 12 U.S.C. sec. 1727(d) and hereinafter sometimes referred to as "section 1727(d) payments") equal to two percent of any net increase in the total amount of its insured accounts during the previous year, reduced, however, by an amount equal to any requirement, as of the end of such year, for the purchase of stock in a Federal Home Loan Bank of which

---

Footnote 1—Continued

(e) Credits to Secondary Reserve; availability for losses; assignment or transfer of share of Reserve.

The Corporation, in accordance with such regulations as it may prescribe, shall credit to the Secondary Reserve, as of the close of each calendar year a return on the outstanding balances of the Secondary Reserve during such calendar year, as determined by the Corporation, at a rate equal to the average annual rate of return to the Corporation during the year ending at the close of November 30 of such calendar year, as determined by the Corporation, on the investments held by the Corporation in obligations of, or guaranteed as to principal and interest by, the United States. Except as provided in subsections (f) and (g) of this section, the Secondary Reserve shall be available to the Corporation only for losses of the Corporation and shall be so available only to such extent as other accounts of the Corporation which are available therefor are insufficient for such losses. No right, title, or interest of any institution in or with respect to its pro rata share of the Secondary Reserve shall be assignable or transferable, whether by operation of law or otherwise, except to such extent as the Corporation may by regulation or otherwise provide for transfer of such pro rata share in cases of merger or consolidation transfer of bulk assets as defined by the Corporation by regulation or otherwise for the purposes of this sentence, and similar transactions as so defined.

(f) Cessation of prepayments; distribution of share of Secondary Reserve; reinstatement of reserve share; payment; waiver, or other treat of accruals.

If (i) the status of an insured institution as an insured institution is terminated pursuant to any provision of section 1730 of this title or the insurance of accounts of an

Footnote continued on next page.

the insured institution is a member. Public Law 87–210 also amended section 6 of the Federal Home Loan Bank Act (12 U.S.C. sec. 1426), to reduce the percentage of stock which a member of a Federal Home Loan Bank is required to hold in relation to its outstanding home mortgage loans, with certain exceptions relating to stock already purchased, from two to

Footnote 1—Continued

insured institution is otherwise terminated, (ii) a conservator, receiver, or other legal custodian is appointed for an insured institution under the circumstances and for the purpose set forth in subsection (d) of section 1724 of this title, or (iii) the Corporation makes a determination that for the purposes of this subsection an insured institution has gone into liquidation, the obligation of such institution to make prepayments under subsection (d) of this section, including any prepayments as to which such institution is obligated at the time of such termination, appointment, or determination, shall cease, and the Corporation shall pay in cash to such institution its pro rata share of the Secondary Reserve, in accordance with such terms and conditions as the Corporation may prescribe by regulations or otherwise, or, at the option of the Corporation, the Corporation may apply the whole or any part of the amount which would otherwise be paid in cash toward the payment of any indebtedness or obligation, whether matured or not, of such institution to the Corporation, then existing or arising before such payment in cash * * *.

(g) Suspension of prepayments, resumption of obligation upon insufficiency of aggregate reserves; cash distribution of shares of Secondary Reserve.

If, at the close of any December 31, the aggregate of the Primary Reserve and the Secondary Reserve equals or exceeds 2 per centum of the total amount of all accounts of insured members and creditor obligations of all insured institutions but the Primary Reserve does not equal or exceed such 2 per centum, no insured institution shall be obligated to make any prepayment under subsection (d) of this section during the year beginning with May 1 next succeeding such close, and each insured institution's pro rata share of the Secondary Reserve shall be used to the extent available, to discharge such institution's obligation for its premium under subsection (b) of this

Footnote continued on next page.

one percent. It was contemplated that, for most member institutions, the section 1727(d) "prepayment requirement would be approximately offset" by the resulting reduction in outlays for Federal Home Loan Bank stock which a member institution was theretofore (prior to 1962) required to make. H. Rept. No. 823, 87th Cong., 1st Sess., p. 2.

Under the terms of section 1727, as amended by Public Law 87-210, the FSLIC is directed to estab-

---

Footnote 1—Continued

section for the premium year beginning in such year; and the suspension of obligation to make such prepayments and the use of such pro rata shares as provided in this sentence shall continue unless and until the next sentence or the last sentence of this subsection shall become operative. If, at the close of any December 31 occurring before the last sentence of this subsection shall become operative, the aggregate of the Primary Reserve and the Secondary Reserve is not at least equal to 1¾ per centum of the total amount of all accounts of insured members and creditor obligations of all insured institutions (i) the obligation of insured institutions to make prepayments under subsection (d) of this section shall resume on May 1 next following such December 31 and shall continue unless and until the first sentence or the last sentence of this subsection shall become operative, and (ii) the use of any insured institution's pro rata share of the Secondary Reserve under the first sentence of this subsection shall terminate with respect to its premium under subsection (b) of this section for the premium year beginning during the calendar year commencing on May 1 next succeeding such December 31, and such termination shall continue unless and until the first sentence of this subsection shall become operative. If, at the close of any December 31, the Primary Reserve equals or exceeds such 2 per centum, the Corporation shall, at such time (which shall be the same for all insured institutions and shall not be later than May 1 next succeeding such close) and in such manner as the Corporation shall determine, pay in cash to each insured institution its pro rata share of the Secondary Reserve and shall not, after such time, accept or receive further prepayments under subsection (d) of this section.

Footnote continued on next page.

lish a "Primary Reserve," and a "Secondary Reserve". (Section 1727(a)). The Primary Reserve is credited annually with the net income of the FSLIC, and thus represents its "retained earnings." Regular insurance premiums paid by insured institutions under section 1727(b)(1) constitute one of the major items of the FSLIC's gross income, and, to the extent that such premiums exceed expenses and insurance losses in any given year, they are thus transferred as part of FSLIC's net income to the Primary Reserve. Section 1727(d) payments, on the other hand, though described in the statute as "additional premium[s] in the nature of * * * prepayment[s]

Footnote 1—Continued

Public Law 87-210 also amended section 6 of the Federal Home Loan Bank Act (12 U.S.C. sec. 1426) to read as follows:

Sec. 1426. Capital stock.

* * * * *

(c) Minimum subscriptions; retirement of oversubscriptions; limitations; cancellation of oversubscriptions; aggregate unpaid loan principal; reports and information.

(1) The original stock subscription of each institution eligible to become a member under section 1424 of this title shall be an amount equal to 1 per centum of the subscriber's aggregate unpaid loan principal, but not less than $500. The bank shall annually, as of the close of the calendar year, adjust, at such time and in such manner and upon such terms and conditions as the Federal Home Loan Bank Board may by regulations or otherwise prescribe, the amount of stock held by each member so that such member shall have invested in the stock of the Federal Home Loan Bank at least an amount calculated in the manner provided in the next preceding sentence (but not less than $500). If the bank finds that the investment of any member in stock is greater than that required under this subsection it may, unless prohibited by said Board or by the provisions of paragraph (2) of this subsection, in its discretion and upon application of such member retire the stock of such member in excess of the amount so required. Said Board, in its discretion, may, by regulations or otherwise, provide for adjustments in amounts of stock to be issued or retired in order that stock may be issued or retired only in entire shares.

with respect to future premiums," are not regarded as an item of income by the FSLIC, which is required by section 1727(a) to credit all such payments directly to the "Secondary Reserve." The FSLIC is also required to credit the "Secondary Reserve" with an annual "return" on the outstanding balances in that account at the end of each year, computed "at a rate equal to the average annual rate of return to the Corporation * * * on the investments held by the Corporation in obligations of, or guaranteed as to principal and interest by, the United States." Section 1727(e). Finally, whereas the "Primary Reserve" is "the general reserve of the Corporation [i.e., the FSLIC]," the "Secondary Reserve" is available "only for losses of the Corporation and shall be so available only to such extent as other accounts of the Corporation which are available therefor are insufficient for such losses." Section 1727(e).

Each insured institution maintains an interest in a pro rata share of the "Secondary Reserve," and though its "right, title or interest" therein is not generally transferable or assignable, the FSLIC has authority to provide for the transfer of such pro rata share "in cases of merger or consolidation transfer of bulk assets * * * and similar transactions." Section 1727(e). Moreover, an insured institution is entitled to a cash refund of its pro rata share in the event that (1) its status as an insured institution is terminated, or (2) a conservator, receiver, or other legal custodian is appointed for the purpose of liquidating the assets of the institution, or (3) the FSLIC determines that such institution has gone into voluntary liquidation. Section 1727(f).

When, at the close of any December 31, the *aggregate* of the Primary Reserve and the Secondary Re-

serve equals or exceeds two percent of the total amount of all insured accounts and creditor obligations of all insured institutions, the obligation of insured institutions to make section 1727(d) payments will be suspended for the following year and all succeeding years; the obligation to make section 1727(d) payments is to resume in the year following any December 31 on which such aggregate amount falls below 1¾ percent of all insured accounts and creditor obligations, and is to terminate permanently when the amount in the Primary Reserve alone equals or exceeds two percent of such accounts and obligations. In any year in which the obligation to make section 1727(d) payments is suspended, as described above, the pro rata share of each insured institution in the Secondary Reserve will be used, to the extent available, to discharge its obligation to pay the regular insurance premium for that year. After the Primary Reserve alone reaches the two percent level, each insured institution is entitled to the return of its pro rata share of the Secondary Reserve, if any, in cash. Section 1727(g).

A schedule appearing shortly hereinafter sets forth estimates of the reserve position of the FSLIC in terms of the expected ratio of the Primary Reserve, the Secondary Reserve, and the aggregate of the Primary and Secondary Reserves to the total of all accounts and creditor obligations of all insured institutions for the years 1962–1995. These estimates, prepared in the Office of the Comptroller of the FSLIC and submitted to the Senate Committee on Banking and Currency in connection with that Committee's consideration of the bill which became Public Law 87–210, were based upon certain assumptions, *viz:*

400-943—70——3

1. No insurance losses.[2]

2. Premium income computed on annual billing basis of one-twelth of 1 percent.

3. Investment income based on annual average rate of return of 3 percent.

4. Operating expenses based on current rate of expenditure equal to 3.7 percent of premium income.

5. Mortgage loans held estimated at 96 percent of total savings capital.

6. Net home mortgages estimated at 90 percent of mortgage loans held.

7. Annual growth in savings of $7 billion plus dividends at an annual rate of 3 percent.

In addition to the foregoing estimates, the schedule also shows the *actual* percentage of the aggregate of the Primary and Secondary Reserves to the total amount of all accounts and creditor obligations of insured institutions during the years 1963–1967, as shown on the financial statements of the FSLIC for those years. The schedule described above is as follows:

---

[2] The FSLIC, during the 27 years of its existence prior to June 30, 1961, had incurred net insurance losses of only $5.1 million, approximately 1.1 percent of its cumulative gross income.

December 31	Primary reserve—estimated ratio	Secondary reserve—estimated ratio	Aggregate of primary and secondary reserves	
			Estimated ratio	Actual ratio
1962	0.642	0.227	0.869	.....
1963	0.661	0.417	1.078	*1.04
1964	0.685	0.581	1.266	1.20
1965	0.712	0.723	1.435	1.35
1966	0.741	0.849	1.590	1.53
1967	0.773	0.963	1.736	1.62
1968	0.807	1.067	1.874	.....
1969	0.842	1.148	1.990	.....
1970	0.879	1.177	2.056	.....
1971	0.917	1.032	1.969	.....
1972	0.956	0.935	1.891	.....
1973	0.996	0.825	1.821	.....
1974	1.036	0.720	1.757	.....
1975	1.078	0.620	1.699	.....
1976	1.121	0.667	1.787	.....
1977	1.164	0.710	1.874	.....
1978	1.208	0.752	1.960	.....
1979	1.252	0.792	2.045	.....
1980	1.208	0.696	1.904	.....
1981	1.343	0.603	1.946	.....
1982	1.390	0.512	1.902	.....
1983	1.437	0.424	1.860	.....
1984	1.484	0.338	1.822	.....
1985	1.532	0.253	1.785	.....
1986	1.580	1.171	1.751	.....
1987	1.629	0.218	1.848	.....
1988	1.679	0.264	1.943	.....
1989	1.729	0.309	2.038	.....
1990	1.779	0.226	2.005	.....
1991	1.830	0.145	1.975	.....
1992	1.881	0.074	1.955	.....
1993	1.932	.....	1.932	.....
1994	1.984	.....	1.984	.....
1995	2.037	.....	2.037	.....

*As of June 30, 1963.

In summary, according to the FSLIC projections in 1961, the aggregate of the Primary Reserve and the Secondary Reserve would equal or exceed two percent of all insured accounts and creditor obligations of all insured institutions by 1970, and all section 1727(d) payments, together with all amounts credited thereon, would be consumed in discharging the obligation of insured institutions to pay regular insurance premiums by the time that the Primary Reserve itself reaches the two percent level in 1995.

During the years 1962 through 1967, petitioner received annual "Insurance Premium Notices" from the FSLIC charging it with "Annual Premium[s] at rate of $\frac{1}{12}$ of 1%" (of its insured accounts and creditor obligations) in the following amounts:

Year:	*Premiums*
1962	$93,258.58
1963	135,760.52
1964	196,413.86
1965	271,477.00
1966	317,427.60
1967	373,025.38

All such sums were paid by petitioner to the FSLIC in the year assessed.

During each of those same years, petitioner also received from the FSLIC a separate "Notice of Insurance Premium Prepayment," which set forth the amounts due from petitioner, and the manner in which computed, generally as follows:

Year	Increase in accounts of petitioner's insured members (depositors) during preceding year	Gross prepayment (2% of increase in prior year)	FHL bank stock credit	Net amount due June 1
1962	$6,337,974	$126,759.48	0	$126,759.48
1963	44,131,843	882,636.86	0	882,636.86
1964	61,746,484	1,234,929.68	$784,100.00	450,829.68
1965	71,489,450	1,429,789.00	334,700.00	1,095,089.00
1966	61,303,238	1,226,064.76	0	1,226,064.76
1967	(1,944,138)	0	0	0

All such section 1727(d) payments billed to petitioner were paid by it to the FSLIC in the year due.

All section 1727(d) payments have been credited on the books and records of the FSLIC directly to its "Secondary Reserve." Effective with the first of such payments, the FSLIC has maintained separate accounts for each insured institution and annually forwards statements to such institutions showing, among other things, the total amount of section 1727(d) payments made to that time, the interest credited annually by the FSLIC to the account pursuant to section 1727(e), and the insured institution's pro rata share of the Secondary Reserve. Petitioner's account, No. 2066, reflects the following:

Date	Sec. 1727(d) payment	Annual return		Pro rata share of secondary reserve		
		Rate	Amount	Debit	Credit	Balance
May 31, 1962	$126,759.48				$126,759.48	$126,759.48
Dec. 31, 1962		3.151433%	$2,342.10		2,342.10	129,101.58
May 31, 1963	882,636.86				882,636.86	1,011,738.44
Dec. 31, 1963		3.549594%	22,951.42		22,951.42	1,034,689.86
May 28, 1964	450,829.68				450,829.68	1,485,519.54
Dec. 31, 1964		(1)	44,864.25		44,864.25	1,530,383.79
June 1, 1965	1,095,089.00				1,095,089.00	2,625,472.79
Dec. 31, 1965		3.555086%	77,231.97		77,231.97	2,702,704.76
June 1, 1966	1,226,064.76				1,226,064.76	3,928,769.52
Dec. 31, 1966		3.337323%	131,295.86		131,295.86	4,060,065.38
June 1, 1967	0				0	4,060,065.38
Dec. 31, 1967		4.232271%	171,832.97		171,832.97	4,231,898.35
Dec. 31, 1967					[2]690,217.11	4,922,115.46

[1] Not in record.
[2] Transferred from the account of another savings and loan association due to merger.

Section 8701 of the California Financial Code authorizes the Savings and Loan Commissioner to establish a uniform classification of accounts for savings and loan associations and to prescribe the manner in which such accounts are to be kept. On May 21, 1962, the California Savings and Loan Commissioner issued an order prescribing the procedure for accounting for section 1727(d) payments, which order was modified and incorporated into the "Uniform Classification of Accounts" effective January 1, 1963, and,

as modified, has remained effective for all subsequent periods. The "Uniform Classification of Accounts" requires each California savings and loan association to treat section 1727(d) payments as an asset, in an account entitled "Contributions to Secondary Reserve—FSLIC;" to treat the return credited to its pro rata share of the Secondary Reserve as income when notified by the FSLIC that such return has been credited to its account; and to treat transfers made from its pro rata share of the Secondary Reserve to discharge its obligation to pay regular annual premiums as expenses when notified of such transfer.

On petitioner's balance sheet for the year 1962, its section 1727(d) payment for that year, and the statutory interest credited thereon, were included in "Other Assets;" beginning in 1963, all section 1727(d) payments have been shown, on the asset side of the balance sheet, as "Prepaid Federal Savings and Loan Insurance Corporation Premiums." Such payments were not included as an expense on any of its income statements for the periods 1962 through 1966. The interest credited to petitioner's account pursuant to section 1727(e) by the FSLIC for each of the years 1962 through 1966 was included in miscellaneous income for the year in which the interest was credited to petitioner's account by the FSLIC. These items were similarly treated on the Consolidated Financial Statements of petitioner's parent, First Lincoln Financial Corporation, and its subsidiaries. All of petitioner's financial statements for the years 1962 through 1966, and all consolidated financial statements of its parent for those years, were audited by the firm of Peat, Marwick, Mitchell & Co., certified public accountants, which submitted accompanying "Accountant's Reports" stating that the financial position of petitioner

(or its parent) had been presented fairly therein, "in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year."

The regulations of the FHLB Board require each savings and loan association which is a member of the Federal Home Loan Bank system to file, on forms provided by the Board, a semi-annual report of its affairs as of the end of each semiannual period. Printed instructions for the preparation of such reports are published and distributed to each member. The "Introduction" to these instructions states that: "These instructions are provided to assist in the completion of monthly and semiannual reports by members of the Federal Home Loan Bank System. Each reporting institution is urged to carefully follow these instructions * * *." Under the heading "Schedule D, Other Assets," each institution insured by the FSLIC is instructed to report in that category "the amount of its pro rata share in the Secondary Reserve established by the Corporation from the premium prepayments." In all of its reports to the FHLB since 1962 petitioner has reported its pro rata share of the Secondary Reserve as an asset under the heading "Other Assets," as required by such instructions.

On its Federal income tax returns for the years 1962, 1963 and 1964, petitioner deducted both its section 1727(b)(1) regular premium payments and its section 1727(d) payments under "other deductions" as "Federal insurance premiums." Upon examination of its returns for those years, the Commissioner allowed the deduction for amounts paid under section 1727(b)(1), but disallowed a deduction for all section 1727(d) payments. In its petition to this Court, petitioner put in issue the greater part of the deficiency

in its income tax as determined by the Commissioner with respect to the calendar year 1963.[3] It concedes the correctness of all the adjustments made by the Commissioner for 1963 with the exception of his disallowance of a deduction of $882,636.86, the amount of the section 1727(d) payment made by petitioner in that year.

OPINION

RAUM, *Judge*: Petitioner, a savings and loan association licensed by the State of California and doing business in the Los Angeles area, has since 1938 insured the savings accounts of its depositors with the Federal Savings and Loan Insurance Corporation (the "FSLIC"), pursuant to the provisions of Title IV of the National Housing Act, as amended. (12 U.S.C. sec. 1724 *et seq.*) It pays an annual "premium for such insurance" in an amount equal to 1/12 of one percent of the total amount of all its savings accounts and creditor obligations, as provided in section 1727(b)(1). Since 1962, as the result of amendments made to the National Housing Act, petitioner has been required to make further annual payments to the FSLIC under section 1727(d), hereinafter sometimes referred to as "Sec. 1727(d) payments", equal to two percent of any net increase in its insured accounts during the previous year, but reduced in the case of an insured institution, such as petitioner, which is also a member of a Federal Home Loan Bank, by the amount of any required purchase of stock in such Bank for that year. These section 1727(d) payments are described in the statute as "additional premium[s]in the nature of * * * prepayment[s] with respect to future premiums." In 1963, the only year

[3] There was no deficiency in petitioner's income tax in the other years.

here in issue, petitioner paid its annual insurance premium for the year in the amount of $135,760.52, and made its section 1727(d) payment in the amount of $882,636.86. Both sums were deducted on its 1963 Federal income tax return as "Federal insurance premiums." The Commissioner, while not disputing petitioner's right to deduct its regular annual insurance premium, disallowed in full the deduction of $882,636.86 claimed for the additional section 1727(d) payment. The sole issue for decision is whether this latter payment was an ordinary and necessary expense of petitioner's business in 1963, or a capital expenditure deductible, if at all, only in later years to the extent that it ceased to be an asset of petitioner.

Although described in the statute as "an additional premium in the nature of a prepayment with respect to future premiums," the section 1727(d) payment is neither an "additional premium," in the sense of being a mere increase in the annual insurance premium as contended by petitioner, nor a "prepayment with respect to future premiums," at least insofar as the ordinary prepaid insurance premium is taken as a standard. The National Housing Act is not, of course, a revenue statute, and the label attached to section 1727(d) payments therein is not, and was not intended to be, conclusive in the determination of how these payments should be treated for Federal tax purposes. See *McMillan Mortgage Company*, 36 T.C. 924, 928. The label is at any rate ambiguous, though if we were to give it binding effect here, we should most certainly adopt the characterization of "prepayment" as controlling, and would therefore have to deny petitioner a current deduction for its section 1727(d) payment under a long line of decisions by this Court holding that prepaid insurance premiums

are capital expenditures to be expensed over the years in which coverage is actually obtained. *Higginbotham-Bailey-Logan Co.*, 8 B.T.A. 566, 577; *George S. Jephson*, 37 B.T.A. 1117, 1119–1120; *Martha R. Peters*, 4 T.C. 1236, 1242; *Louise K. Herter*, 20 T.C.M. 78, 86. See and compare *Commissioner* v. *Boylston Market Ass'n.*, 131 F. 2d 966 (C.A. 1), affirming a Memorandum Opinion of the Board of Tax Appeals, with *Waldheim Realty and Investment Company* v. *Commissioner*, 245 F. 2d 823 (C.A. 8), reversing 25 T.C. 1216. But regardless of whether the section 1727 (d) payment may properly be characterized as a prepaid insurance premium, we reach the same ultimate result, for an analysis of the substantive provisions of section 1727 convinces us that this payment, however labeled, is in the nature of a capital outlay and is therefore not deductible as an expense in the year that it is made.

That the section 1727(d) payment is qualitatively different from the regular annual insurance premium payable under section 1727(b)(1), and constitutes something more than a mere increase in the premium rate, seems to us beyond question. Regular annual premiums are part of the gross income of the FSLIC and, along with its income from investments, are used to meet the FSLIC's operating expenses and insurance losses, if any, for the year. To the extent that such premiums are not so used, they are transferred, as part of the FSLIC's net income for the year, to the "Primary Reserve," the FSLIC's general reserve which contains its cumulative net income or "retained earnings" and which is available to meet the FSLIC's insurance losses if its income in any year is insufficient for this purpose. Section 1727(d) payments, on the other hand, are not considered as income by the FSLIC, and are not ordinarily available to meet the

annual expenses and losses of the Corporation. Instead, the FSLIC is required by statute to credit all such payments directly to a "Secondary Reserve," which is to be used "only for losses of the Corporation and shall be so available *only to such extent as other accounts of the Corporation which are available therefor are insufficient for such losses.*" Section 1727 (e). (Emphasis added.) Thus, instead of being taken into income, freely available to meet expenses and losses of the current year, the section 1727(d) payment is credited directly to an account, rather like a capital account, which may be applied against losses only in the event that the regular insurance premiums for the year, the corporation's other income, and its retained earnings of prior years have all been depleted. It cannot, therefore, be accurately termed a premium for insurance coverage in the year of payment, but, at least initially, is in reality a capital investment in the FSLIC, part of a pool or capital available to the FSLIC for the payment of losses in the event of emergency.

Furthermore, when the regular insurance premiums paid by insured institutions under section 1727 (b)(1) are received by the FSLIC, they lose their distinctive character as premiums and become merely part of the gross income of the corporation; the insured institution retains no rights in respect of such sums, other than the right to insurance coverage for the current year, and its premium, once paid, is lost to it forever. Payments made under section 1727(d), however, stand on quite a different footing. Such payments, as noted above, are immediately segregated in the "Secondary Reserve," and the FSLIC is directed by statute to credit the outstanding balance in this account, on an annual basis, with a "return"

computed "at a rate equal to the average annual rate of return to the Corporation * * * on the investments held by the Corporation in obligations of, or guaranteed as to principal and interest by, the United States." Section 1727(e). What is more, each insured institution maintains an interest in a pro rata share of the Secondary Reserve, and is annually furnished with a statement of its account by the FSLIC, which keeps a separate account for each insured institution. That annual statement discloses all section 1727(d) payments made by the insured institution, the interest or return earned by the account, any debits that may have been charged aganist the account, and, finally, the new balance in the account as of the end of the year. Thus, for the years 1962–1967, petitioner's account, set forth in our findings, reflects various credits (section 1727(d) payments and interest or return), no debits, and a balance of $4,922,115.46 in its favor, representing its pro rata share in the Secondary Reserve as of December 31, 1967.

While petitioner's pro rata share of the Secondary Reserve is not, as a general rule, assignable or transferable, "by operation of law or otherwise," the value of such share may be fully realized through its transfer to another insured institution in a merger, consolidation or bulk sale; petitioner may even receive the value of its share from the FSLIC in cash if (1) its insured status is terminated, either voluntarily or involuntarily, (2) it goes into liquidation, voluntarily are involuntarily, or (3) the obligation to make section 1727(d) payments is permanently terminated and the Secondary Reserve distributed before the value of its share has otherwise been fully recovered. See p. —, *infra*. Moreover, assuming petitioner does not realize the value of its pro rata share in one of the above ways, it is reasonably assured of receiving

full value therefor in the form of insurance coverage in future years when its share of the Secondary Reserve is used to pay its regular section 1727(b)(1) premiums. To the extent that the petitioner's share is so used, entries will undoubtedly be made in the debit column of its account which will be reflected in the balance appearing as of the end of each such year. Also, to the extent that any losses may be charged in any year against the Secondary Reserve, petitioner's pro rata share thereof should similarly appear in the debit column, thereby also adversely affecting its balance as of the end of such year. And to the extent that any such debits are charged against petitioner's balance in any particular year, whether for regular section 1727(b)(1) premiums or for losses, it would seem that petitioner would be entitled to deductions in those amounts for any such year. Cf. Rev. Rul. 66–49, 1966–1 C.B. 36, 37.

As already noted, the Secondary Reserve is available for the payment of losses, but only to a very limited extent. It has, however, never been used for this purpose, nor, on the basis of the FSLIC's past loss experience, does such use appear to be likely. At the time that Congress considered Public Law 87–210, in 1961, net insurance losses of the FSLIC had absorbed only 1.1 percent of its gross income over its entire existence, H. Rept.No. 823, 87th Cong. 1st Sess. p. 2 (1961); S. Rept. No. 778, 87th Cong. 1st Sess. p. 2, and the financial statements of the FSLIC put in evidence by the parties, covering all the years thereafter through December 31, 1967, reveal no year in which the net insurance losses of the FSLIC exceeded even its investment income, much less the annual premiums for the year and/or the Primary Reserve, both of which must be fully consumed before

the Secondary Reserve can be utilized. The Primary Reserve alone stood at $921,669,395 on Deember 31, 1967, while the *cumulative* net losses of the FSLIC from June 27, 1934 through December 31, 1967, totalled only $105,610,365. Of course, an event of catastrophic proportions, another Great Depression, could conceivably wipe out the Secondary Reserve, but the probability that such an event will occur is simply incalculable. It is certainly not an event that could reasonably be anticipated as of any particular time, and if any event should occur requiring a charge against the Secondary Reserve in respect of any loss, petitioner's pro rata share thereof would then be deductible, as has already been pointed out. But there do not appear to be any greater hazards in this respect than attach to the capital investment made by a stockholder in a commercial bank or an insurance company.

Though it is clear that "prepayments" under section 1727(d) are not really insurance premiums, at least not in the year in which they are paid, a further examination of the provisions of Public Law 87-210 also reveals sharp differences between such "prepayments" and the ordinary prepaid insurance premium. While the average prepaid insurance premium gives rise to an obligation on the part of the insurer to provide coverage for some definitely ascertainable period of time, usually not more than two or three years from the date of the policy, the FSLIC incurs no such obligation upon its receipt of a section 1727(d) payment. The obligation to provide insurance coverage does not arise until the section 1727(d) payment is actually used to discharge the obligation of the insured institution to pay a regular section 1727(b)(1) insurance premium, which event is contingent upon the ratio of the FSLIC's reserves to its potential liabilities attaining certain levels. Moreover, since the section

1727(d) payment credited to the Secondary Reserve is subject to accretion through the annual "return" credited annually by the FSLIC on the outstanding balance in such reserve, and at least theoretically to depletion in the event the reserve is used to meet losses in an emergency situation, and since the regular annual premium required by section 1727(b)(1) is itself a percentage of the insured institution's accounts and creditor obligations, and thus varies from year to year, there is no way of predicting with certainty the number of years of insurance coverage which will be procured by each section 1727(d) payment, much less the precise years which will be covered. Thus, unlike the common prepaid insurance premium, the section 1727(d) payment is not simply "an exhaustible asset with a determinable life" whose value may be allocated "ratably over the term for which the premium is paid," see *George S. Jephson, supra,* 37 B.T.A. 1117, 1120; *Higginbotham-Bailey-Logan Co., supra,* 8 B.T.A. 566, 577, the life of the asset created by the section 1727(d) payment is not determinable on the date of payment, and its usefulness will not be ratably spread over the period of that life.

For the period of time prior to its use to discharge the obligation of the payor institution to pay regular annual premiums required by section 1727(b)(1), the section 1727(d) payment will simply constitute part of the capital of the FSLIC. Under the terms of the statute, section 1727(g), the pro rata share of each insured institution in the Secondary Reserve will be used to pay its regular annual premiums, and the obligation of insured institutions to make section 1727(d) payments will concurrently be suspended, only after the aggregate of the FSLIC's Primary and Secondary Reserves equals or exceeds two percent of

the total amount of all savings accounts and creditor obligations of institutions insured by the FSLIC. The obligation to make section 1727(d) payments will, however, resume, if the aggregate of the two reserves subsequently falls below 1¾ percent of the FSLIC's potential liabilities, and, until such aggregate again reaches the two percent level, the use of the pro rata share of each insured institution to pay its regular annual premiums must also cease. It is not until the FSLIC's Primary Reserve alone equals or exceeds two percent of its potential liabilities that the obligation to make section 1727(d) payments will permanently terminate, at which time insured institutions are entitled to the refund of their pro rata share of any amount remaining in the Secondary Reserve. Clearly then, the effect of these provisions is to require insured institutions to make and keep capital investments in the FSLIC, until it has retained enough of its own earnings (in the Primary Reserve) to provide, in the opinion of Congress, adequate protection for insured savers.

To be sure, the asset acquired by petitioner by virtue of its section 1727(d) payments, i.e., its pro rata share of the FSLIC's Secondary Reserve, differs in many respects from the usual capital investment. Petitioner is required by law to make the investment, at least as long as it wishes to insure its accounts with the FSLIC, cf. *Hotel Sulgrave, Inc.*, 21 T.C. 619, the amount of the investment is determined by the growth of its business, i.e., the increase in its savings accounts, and the asset so acquired is ordinarily not transferable to others. But these differences, though perhaps not insignificant for other than tax purposes, cannot alter the fact that the section 1727(d) payment does not actually provide insurance coverage for petitioner in the year of payment, and is not an ordi-

nary and necessary expense of that year; it results in the acquisition of an asset which, if held to "maturity" and not transferred in a merger, consolidation or bulk sale, and not refunded in the event of a termination of insurance or liquidation, will result in benefits, in the form of insurance coverage, in future years. In these circumstances, it is a matter of no consequence whether petitioner is a cash or accrual basis taxpayer, for the rule is the same for both that: "If an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made." Regs. sec. 1.461–1(a)(1) and (2). Moreover, we need not look far to find a similar investment which, though possessing many of these same peculiar attributes, is nevertheless a capital expenditure. An example readily at hand lies in the payment by petitioner of amounts required by section 6 of the Federal Home Loan Bank Act, 12 U.S.C., section 1426(c), for the acquisition of capital stock in its Federal Home Loan Bank, a payment which we think is closely analogous to the section 1727(d) payment here, and which petitioner has consistently capitalized rather than expensed in the year of payment.

Membership in a Federal Home Loan Bank entitles a savings and loan association to obtain advances from such Bank, up to certain limits, upon the security of its home mortgages and obligations of or guaranteed by the United States, 12 U.S.C. section 1430(a); it thus serves the important function of providing members with a source of additional liquidity and funds for mortgage lending. As a condition of membership, the savings and loan association must initially purchase stock in one of twelve regional Home Loan

400-943—70——4

Banks, depending upon the district in which it is located, equal to one percent of such association's "aggregate upaid loan principal," [4] and must purchase such additional amounts of stock thereafter as is necessary to maintain this ratio at the close of each succeeding calendar year. 12 U.S.C. sec. 1426(c)(1). Amounts so invested are not ordinarily transferable, and, in general, are returnable to the member only upon its withdrawal from membership. Also, if at the time of withdrawal the FHLB Board finds that the paid-in capital of the member's Federal Home Loan Bank is or is likely to be impaired as a result of losses in or depreciation of the assets held by such Federal Home Loan Bank, the amount to be paid the member in retirement of its stock is reduced by its pro rata share of the amount of the impairment. 12 U.S.C. sec. 1426(i). The similarities between the mandatory payments made by petitioner to its Federal Home Loan Bank and those made to the FSLIC are thus strikingly apparent.[5] True, petitioner did not re-

[4] Defined as the aggregate unpaid principal of its home mortgage loans, home-purchase contracts, and similar obligations. 12 U.S.C. sec. 1426(c)(4).

[5] Petitioner argues that the legally compelled investments made in its Federal Home Loan Bank are fundamentally distinguishable from the section 1727(d) payments here by virtue of the fact that it is entitled to dividends on its Federal Home Loan Bank stock which are immediately available for its use, and the further fact that the Federal Home Loan Bank may, "in its discretion," retire the stock of any member to the extent that it exceeds the required ratio. Although these are distinctions, they are nevertheless distinctions without a difference here. We do not consider it significant that petitioner's annual dividends on its Federal Home Loan Bank stock are distributed to it rather than being credited to its account, nor do we think it important that petitioner may receive some of the funds invested in the Federal Home Loan Bank

ceive any pieces of paper to evidence its pro rata share of the Secondary Reserve, though one could imagine a redeemable preferred stock which incorporated all the provisions of sections 1727(d), (e), (f) and (g) as described above, which might have been issued in exchange for such payments. But it acquired an asset nevertheless, if evidenced only by the annual statements sent to petitioner every year showing the status of such pro rata share. That the section 1727(d) payment made to acquire that asset was mandatory and based upon the volume of petitioner's business, and that the asset itself was nontransferable and subject to a limited extent to the losses of the corporation in which the funds were invested, does not make it any more an ordinary and necessary expense, nor less a capital expenditure, than the required investments made by petitioner in its Federal Home Loan Bank.

Moreover, the section 1727(d) payments, which are measured by the net increase of the institution's insured accounts during the preceding year, were in fact regarded by Congress, in part at least, as being a substitute for investments in the capital stock of the Federal Home Loan Banks which member in-

---

before it begins to receive, actually or constructively, its section 1727(d) payments. Moreover, assuming that it remains a member of both the Federal Home Loan Bank and the FSLIC indefinitely, petitioner will certainly receive its total investment in the FSLIC before it receives the money it has invested in its Federal Home Loan Bank, for while there is a definite limit on petitioner's commitment to the FSLIC, there is none on its commitment of funds to the Federal Home Loan Bank. At any rate, the question of when such investments or the return thereon, will be redeemed is simply a question of timing; the important point is that both are in fact capital investments.

stitutions were theretofore required to make. A member institution was formerly obligated to purchase and hold such capital stock equal to two percent of its outstanding home mortgage loans, but when its obligation to make the section 1727(d) payments commenced in 1962, the two percent level in respect of the capital stock was simultaneously reduced to one percent. It is clear that Congress regarded these as interrelated events,[6] and in our judgment the 1727(d) payments represented capital outlays by the member institution just as much as its investment in the stock of its regional Federal Home Loan Bank.

The legislative history of Public Law 87–210, which amended section 1727 to its present form in 1961, does not of course deal with the manner in which section 1727(d) payments should be treated for Federal tax purposes, but it is certainly not inconsistent with anything we have said here. The decade preceding the enactment of the bill witnessed a tremendous increase in the growth of institutions insured by the FSLIC, and a concomitant growth in the total amount of savings insured by the Corporation. But, in that same decade, the FSLIC was required by Congress to use its income to retire all of its capital stock, in the amount of $100,000,000, from the United States Treasury. The result was a decline in the ratio of the reserves of the FSLIC to its potential liabilities during this period from 0.843 percent to 0.661 percent. See S. Rept. No. 778, 87th Cong., 1st Sess., pp. 2, 12; Hearings Before Subcommittee No. 1 of the Committee on Banking and Currency, House of Representatives, 87th Cong., 1st Sess., on H.R. 7108 and H.R. 7109, pp. 10, 39. Public Law 87–210 was "designed to add new strength" to the FSLIC by requiring in-

[6] See *infra*, p. —.

sured institutions to make so-called "premium prepayments" which, it was hoped, "would result in a marked acceleration in building up the Corporation's reserves." H. Rept. No. 823, 87th Cong., 1st Sess., p. 2 (1961); S. Rept. No. 778, *supra,* pp. 1–2.

Petitioner emphasizes that Congress spoke in terms of building up the FSLIC's *reserves,* that section 1727(d) payments are in fact credited to a "Secondary Reserve," and concludes that a necessary corollary is that payments made to a reserve must be insurance premiums. This is no more than semantic word play. The truth of the matter is that, for the reasons outlined at the beginning of this opinion, section 1727(d) payments cannot be considered merely additional insurance premiums. Had Congress felt that the premium income of the FSLIC was inadequate to meet expenses and losses, it could easily have increased the regular annual premium to what it considered a more realistic level, without enacting all the complicated provisions which govern section 1727(d) payments. But, in fact, during the entire life of the corporation its total expenses had, to 1961, amounted to only 3.7 percent of its gross income while net insurance losses had absorbed "a mere 1.1 percent of the gross income." Hearings, *supra,* p. 10. Cf. H. Rept. No. 823, *supra,* p. 2, S. Rept. No. 778, *supra,* p. 2. What was needed was additional capital, not additional premium income, which would serve as a buffer until the FSLIC had accumulated enough of its own income to bring its "Primary Reserve," the true insurance reserve, to the desired two percent level.[7]

[7] Compare the statement of Everett C. Sherbourne, vice-chairman, Federal Legislation Committee, National League of Insured Savings Associations, Hearings, *supra* p. 45. "From the standpoint of the loss experience of the Corporation, we do not believe the reserve would be inadequate * * *. There is, how-

True, Congress called the account to which this additional caiptal was credited a "Secondary Reserve," but since such "reserve" served the same function as a capital account, and was available for losses "only to such extent as other accounts of the Corporation which are available therefor are insufficient for such losses," Congress' use of the terminology of the insurance industry should not confuse the issue. And what, after all, is the capital account of any corporation if not a "Secondary Reserve," a pool of capital available to creditors in the event that the corporation's current income and retained earnings are not sufficient to satisfy their claims?

As has previously been pointed out, at the same time and in the same measure directing insured institutions to make these additional section 1727(d) payments to the FSLIC, Congress reduced the ratio of stock which members of a Federal Home Loan Bank were required to hold against their "unpaid loan principal" from two to one percent. It was contemplated that "[f]or most institutions, this prepayment requirement [i.e., section 1727(d) payments] would be approximately offset by reducing the stock the institution must purchase in its Federal home loan

---

ever, an inadequacy of working capital." This witness went on to explain that the FSLIC does not "sit idly by, wait for a loss to occur, and then pay out insurance * * *", but has authority to take steps, such as the making of loans to institutions in danger of failing, which "may involve substantial cash disbursements without ultimate loss to the Corporation."

The savings and loan industry supported Public Law 87-210, see S. Rept. No. 778, 87th Cong., 1st Sess., pp. 5, 12–13, in line with its "longstanding position" that savings and loan associations should finance "their Insurance Corporation" rather than "rely on taxpayer funds for this purpose." See S. Rept. No. 378, 89th Cong., 1st Sess., pp. 71–72 (1965).

bank." See H. Rept. No. 823, *supra,* p. 2; S. Rept. No. 778, *supra,* pp. 1–2. In essence, then, Public Law 87–210 provided that funds which would otherwise have gone into the capital structure of the Federal Home Loan Banks, which already had "more than sufficient [amounts invested in capital stock] to meet the criterion of adequate capitalization," see Hearings, *supra,* p. 9, would be channeled instead to the FSLIC's Secondary Reserve, which is itself essentially a capital account, though more temporary in nature. Moreover, to the extent that an insured institution is required to purchase additional stock in its Federal Home Loan Bank, its section 1727(d) payment to the FSLIC is reduced by the amount of stock so purchased. Clearly, if the section 1727(d) payments represented actual insurance premiums needed by the FSLIC to meet its expenses and losses, rather than merely a capital cushion for the FSLIC, this arrangement would not have been feasible. The fungibility of capital stock payments to the Federal Home Loan Bank and section 1727(d) payments to the FSLIC under Public Law 87–210 strongly suggests that Congress thought of both as serving roughly the same purpose.

The conclusion then, is inescapable that section 1727(d) payments result in the creation of an asset in the nature of a capital investment which should, however, eventually be used to provide insurance coverage in future years, and that for Federal income tax purposes at least, such payments must be capitalized and deducted from gross income only in the years and to the extent actually used to provide such insurance coverage or actually drawn upon to meet losses. Regs. section 1.461–1(a), *supra.* Nor are we convinced by petitioner's argument and the testimony of its expert

witnesses, that even as a matter of general accounting practice a section 1727(d) payment should be written off immediately because of uncertainty as to whether and when it will benefit the insured institution. We have already demonstrated that, for all practical purposes, these payments will definitely be used to discharge the obligation of the insured institution to pay regular annual premiums in future years, assuming it has not previously transferred its pro rata share of the Secondary Reserve or received a cash payment in respect thereof from the FSLIC. Even the years in which the Secondary Reserve will be available for such use are not wholly a matter of conjecture, for the Office of the Comptroller of the FSLIC has made projections in this regard, showing, inter alia, that the aggregate of the Primary and Secondary Reserves of the FSLIC will equal or exceed two percent of the FSLIC's potential liabilities by 1970, and will thereafter be available for payment of regular annual premiums in subsequent years (except those in which the aggregate of the reserves falls below 1¾ percent of the FSLIC's potential liabilities, as disclosed in the projection) until 1995, when the Primary Reserve is expected to equal or exceed the two percent ratio by itself.[8] See Findings of Fact, p.—, *supra*.

[8] The projections made by the FSLIC are, of course, based on a number of assumptions, and are not infallible. Still, they have been proven relatively accurate for the first five years since the enactment of Public Law 87-210, and, in its annual report for 1966, the FHLB Board (which administers the FSLIC) stated that it expected the aggregate of the Primary and Secondary Reserves to reach the two percent level by 1971, as compared to the prediction of 1970 in the original FSLIC estimate. To be sure, these estimates will not allow an insured institution to compute with pinpoint accuracy the years in which its section 1727(d) payments will be used to provide insurance coverage, but they do at least allow it to make a rough approximation.

Moreover, the fact of the matter is that both the California Savings and Loan Commissioner and the FHLB Board require that section 1727(d) payments be capitalized and shown on the financial statements of insured institutions as an asset, to be expensed only in the years in which actually used to satisfy the insured institution's obligation to pay a regular section 1727(b) insurance premium. It is, of course, well established that methods of accounting prescribed by regulatory agencies are not controlling for Federal tax purposes, *Old Colony R. Co.* v. *Commissioner,* 284 U.S. 552, 562; *Bellefontaine Federal Savings and Loan Association,* 33 T.C. 808, 811–812, but where, as here, the accounting treatment prescribed for a particular expenditure appears to be prompted not by any particular statutory or regulatory requirements (indeed, it would seem that agencies charged with the supervision of financial institutions would be quite anxious that the assets and net income of such institutions not be overstated) but rather to be based upon sound accounting principles, it should not be wholly disregarded. Furthermore, the financial statements of both petitioner and its parent, the First Lincoln Financial Corporation reported the section 1727(d) payments here in issue as assets, not expenses, and the firm of certified public accountants which audited such financial statements was able to state, in the Accountant's Report preceding such financial statements, that they presented fairly the financial position of petitioner and its parent "in conformity with generally accepted accounting principles * * *."

We are aware that the same issue that confronts us here was raised, and recently decided in favor of the taxpayer, in *First Federal Savings & Loan Ass'n. of St. Joseph* v. *United States,* 22 AFTR 2d 5238

(W.D. Mo. 1968),[9] the only case in which the issue herein has been adjudicated. The District Court there refused to follow Rev. Rul. 66–49, 1966–1 C.B. 36, in which it was stated that section 1727(d) payments were not deductible as ordinary and necessary expenses. The court held that section 1727(d) payments were deductible in the year of payment, relying on the fact that insured institutions are "subject to the basic liability" to make such payments, that the funds were "paid with respect to insurance coverage and * * * [were] based, to a certain extent, upon the risk of loss," and "of even more significance," upon the fact that such payments "were subject to being completely consumed in the event of a loss." We have already expressed our opinion on these matters, and, being of the view that section 1727(d) payments are nondeductible capital expenditures, we respectfully decline to follow the holding of the District Court. Though we prefer to rest our holding upon the reasons set forth in this opinion, we do agree with the conclusion reached in Rev. Rul. 66–49 that section 1727(d) payments are not ordinary and necessary expenses in the year of payment and are not deductible until they are used to pay regular premiums or losses, or the possibility of their return to the institu-

[9] That case involved a Federal savings and loan association which, unlike petitioner, a state-chartered association, was required and not merely permitted to insure its accounts with the FSLIC. Thus, it did not have the option, available to petitioner, of terminating its insured status without going into liquidation, while petitioner, theoretically at least, could cease being an insured institution of the FSLIC, receive its pro rata share of the Secondary Reserve in cash, and still remain in business. We need not discuss further whether this alternative was open to petitioner as a practical matter, and do not express any opinion as to the significance of this distinction, for our disagreement with the District Court's opinion goes to the more basic issue of the inherent nature of the section 1727(d) payment.

tions is otherwise precluded. Rev. Rul. 66–49, *supra*, 1966–1 C.B. 36, 37.[10]

Because of the unusual nature of the section 1727(d) payments in issue, the remaining cases and rulings cited by both petitioner and respondent are, for the most part, distinguishable on their facts. Thus, cases cited by petitioner for the proposition that an ordinary and necessary business expense is not rendered nondeductible because there remains after payment a contingent possibility of future recovery, e.g. *Alleghany Corporation*, 28 T.C. 298, 305; *Electric Tachometer Corp.*, 37 T.C. 158; and cf. I.T. 2764, XIII–1 C.B. 45, IT. 3632, 1943 C.B. 114,[11] Rev. Rul.

[10] It was also held in Rev. Rul. 66–49 that the annual return credited to each insured institution on amounts in its pro rata share of the Secondary Reserve does not constitute taxable income to an insured institution on the cash basis until actually or constructively received by it, either by way of refund or by its use to discharge the insured institution's obligation to pay annual premiums. Petitioner, while of course not disparaging the Commissioner's position on this matter, claims it is inconsistent with his position on the deductibility of the section 1727(d) payments. The question of when this annual "return" must be included in the income of a cash basis taxpayer is not now before us, and we express no opinion thereon. We do note, however, that the position we take here, that section 1727(d) payments are nondeductible capital expenditures, is no inconsistent with the Commissioner's position as to the time for inclusion of the annual return on income.

[11] I.T. 2764, replied upon by petitioner, was declared obsolete in Rev. Rul. 68–100, 1968–9 I.R.B. 24. It involved payments made to a temporary insurance fund set up by the Federal Deposit Insurance Corporation in the first days of its creation, and relied upon G.C.M. 8474 IX–2 C.B. 281 which was shortly thereafter revoked by the Commissioner. G.C.M. 13290, XIII–2 C.B. 313. See text concerning the Texas State Depositor's Guaranty Fund, p. —, *infra*. I.T. 3632, another ruling cited above upon which petitioner relies, cited as its only authority I.T. 2764. Both I.T. 2764 and I.T. 3632, however, are also distinguishable on their facts, as is noted above.

62, 1953–1 C.B. 71, are of no help to petitioner here since it failed to establish the necessary initial foundation required by these cases; i.e., that the amount of $882,636.86 paid by it to the FSLIC in 1963 pursuant to section 1727(d) constituted an ordinary and necessary expense of that year. Cf. *Harry W. Williamson*, 37 T.C. 941, 944. Nor, on the other hand, were these payments merely security deposits in the nature of a reserve for contingent liabilities as suggested by respondent. Cf. *Spring Canyon Coal Co.* v. *Commissioner*, 43 F. 2d 78 (C.A. 10), certiorari denied 284 U.S. 654; *Wayne Title & Trust Co.* v. *Commissioner*, 195 F. 2d 401 (C.A. 3); *Wolfington Body Co.* v. *Smith*, 99 F. Supp. 788 (E.D. Pa.). Compare *Weber Paper Company* v. *United States*, 204 F. Supp. 394 (W.D. Mo.) affirmed, 320 F. 2d 199 (C.A 8), with Rev. Rul. 60–275, 1960–2 C.B. 43. Perhaps most closely approximating the situation in this case are those cases and rulings involving payments made by Texas State banks during the 1920's to the Texas State Depositor's Guaranty Fund, which, because they shed some light on the section 1727(d) payments involved herein, we now set forth in some detail.

Texas statutes required every state bank to protect its depositors either by a bond or policy of insurance, or by becoming a contributor to the Depositor's Guaranty Fund. If the latter method was elected, the bank was required to make annual contributions to the Fund based upon its average deposits, one-fourth in cash to the State Treasury on which the bank was entitled to interest, though not payable until its liquidation or withdrawal from the Fund, and three-fourths as a deposit on its books to the credit of the State Banking Board. These "regular contributions" were to continue until the Fund contained five million dollars. If a contributing bank failed, whatever money

was needed to pay its depositors was taken from the Fund, which was then immediately reimbursed by a special cash assessment levied on the contributing banks. Such "special assessments" could not exceed two percent of a bank's total average daily deposits in any one year, so that, in any year in which losses exceeded this amount, recourse was had to the Fund itself, and the "regular contributions" to the Fund would resume until it again reached five million dollars. Each participating bank's prorata share of the Fund was returnable to it upon its withdrawal from the Fund or upon its liquidation.

The proper treatment to be accorded the regular contributions to the Fund for Federal income tax purposes became a matter of some controversy. The Bureau of Internal Revenue first held that they were deductible as "necessary business expenses," I.T. 1258, I-1 C.B. 281, but soon revoked this ruling in I.T. 2208, IV-2 C.B. 81. The position was then taken that the contributions were not deductible since they "remain assets of such participating banks. Each participating bank retains at all times an interest in the fund equal to the unexpended portion of its contributions thereto, the amount whereof is readily determinable * * *". S.M. 3877, IV-2 C.B. 79. The Board of Tax Appeals did not agree with this approach, holding in *First State Bank of Bracketville,* 9 B.T.A. 975, followed in *First State Bank of Weimar,* 10 B.T.A. 396, that such contributions were deductible since they were paid "pursuant to a definite liability fixed by law." *First State Bank of Bracketville,* 9 B.T.A. 975, 980. The Bureau thereupon modified its position to conform to that of the Board of Tax Appeals. G.C.M. 8474, IX-2 C.B. 281.

However, the Board was again confronted with this issue in *Wichita State Bank & Trust Co.,* 27 B.T.A.

822. In that case, the taxpayer bank had withdrawn from the Fund and had received its pro rata portion thereof, and the issue raised was whether such amount was includible in its income. The Commissioner said it was, relying on his newly revised position on this matter following the *Bracketville* and *Weimar* cases, contending that since the regular contributions to the fund were deductible, their return to the taxpayer constituted taxable income. The Board, following its prior decisions, agreed. On appeal, in an opinion which we now think correctly disposed of this matter, the Fifth Circuit reversed the Board on this issue, holding that the regular contributions were not ordinary and necessary expenses but nondeductible capital expenditures. *Wichita State Bank & Trust Co.* v. *Commissioner,* 69 F. 2d 595 (C.A. 5). Keeping in mind the similar characteristics of these "regular contributions" and the section 1727(d) payments here in issue, the following comments of the Fifth Circuit are instructive (69 F. 2d at 596):

> * * * That fund [i.e., the permanent five million dollar Guaranty Fund] is not intended to be lost or consumed, but is to stand as a reservoir drawn on to provide prompt payment to depositors, but to be at once replenished by the special assessments. It is analogous to the capital of an insurance company. Each bank owns its pro rata part in it, which it ought ultimately to get back. * * * We think the contributions to the $5,000,000 Guaranty Fund, while made annually instead of in a lump sum, were essentially capital investments and ought to be dealt with as such.

Here the matter of the "regular contributions" was finally settled, the Commissioner indicating agreement with the Fifth Circuit's opinion by reinstating S.M. 3877. G.C.M. 13290, XIII–2 C.B. 313.

We hold that the section 1727(d) payment of $882,636.86 made by petitioner in 1963 was a nondeductible capital expenditure, that the Commissioner correctly disallowed a deduction for this sum, and that the deficiency determined in petitioner's income tax for 1963 in respect of that disallowance was proper.

Petitioner has made an alternative argument that the Commissioner's attempt to assess and collect the deficiency here violated its constitutional rights under either Article II, section 3 (directing the President to "take care that the laws be faithfully executed") or the Fifth Amendment to the Constitution (the due process clause). Petitioner relies on the fact that in the *First Federal Savings & Loan Ass'n. of St. Joseph* case, discussed above, a tax refund suit in which the taxpayer savings and loan association sued to recover taxes which it alleged were erroneously paid for 1963, 1964 and 1965 due to its failure to deduct section 1727(d) payments made in those years, the Government tried to settle by offering to pay the amount sought by the taxpayer and to dismiss the action with prejudice, though it did not wish the terms of the settlement to be included in the final stipulation. It should be noted that the taxpayer refused this offer, and the District Court went to extraordinary lengths in ruling that the refund suit had not become moot. The District Court thereupon adjudicated the issue on the merits in the taxpayer's favor. Petitioner nevertheless contends that the mere fact that the offer of settlement was made to the taxpayer in the *St. Joseph* case is fatal to the determination of the deficiency herein on Constitutional grounds. We think that the point is without merit.

The position taken by the Commissioner in this case in respect of section 1727(d) payments made to the

FSLIC is the same as that in Rev. Rul. 66–49, published in Cumulative Bulletin 1966–1, p. 36. We have carefully examined that position, as it relates to the facts of this case, and have found the deficiency determined by the Commissioner in petitioner's income tax for 1963 was justified by the provisions of the Internal Revenue Code of 1954. We cannot and will not go further and examine the Commissioner's reasons and motives for determining the deficiency in this case and defending his position in response to the petition for a redetermination filed by petitioner in this Court. See *Charles Crowther,* 28 T.C. 1293, 1301, affirmed 269 F. 2d 292, 293 (C.A. 9). Petitioner has no ground to object merely because some other taxpayer may have been offered a windfall as a result of the Government's litigation strategy. Whatever may have been the Government's litigation strategy in attempting to dispose of the *St. Joseph* case, it is not a matter about which the petitioner herein has any standing to complain. The history of litigation over the years has been marked by efforts of private litigants as well as the Government to select test cases in such manner as may be thought to further their respective best interests, and the refusal to press some other case has never been thought to create any rights in favor of parties to a case where similar concessions have not been made. Petitioner has been accorded due process of law in the review of the deficiency determined against it by the Commissioner herein and the fact that it has not been offered a windfall, if indeed the offer of settlement in the *St. Joseph* case was such, does not rise to the level of an infringement of its constitutional rights.

Reviewed by the Court.

Decision will be entered for the respondent.

APPENDIX B

United States Court of Appeals for the Ninth Circuit

No. 23,923

LINCOLN SAVINGS AND LOAN ASSOCIATION, APPELLANT

v.

COMMISSIONER OF INTERNAL REVENUE, APPELLEE

February 3, 1970

On Appeal from the Decision of the Tax Court of the United States

Before ELY and HUFSTEDLER, *Circuit Judges,* and THOMPSON,* *District Judge.*

THOMPSON, *District Judge:*

We are asked to review a determination by the Tax Court. A deduction of $882,636.86 from Apellant's gross income for 1963 was contested. The Tax Court held that Appellant's payment, made for inclusion in the Secondary Reserve Account of the Federal Savings and Loan Insurance Corporation (FSLIC) resulted in the acquisition of a capital asset rather than constituting an ordinary and necessary business expense deductible in the year paid as contemplated by 26 U.S.C. § 162(a).

Jurisdiction and scope of review are governed by 26 U.S.C. § 7482.

---

* Hon. Bruce R. Thompson, United States District Judge, Reno, Nevada, sitting by designation.

400-943—70——5

The Tax Court, in its published opinion, Lincoln Savings and Loan Association, Petitioner, v. Commissioner of Internal Revenue, Respondent, Docket No. 325–67, 51 T.C. 82, made a comprehensive and accurate statement of the facts. Also in that opinion, as well as in *First Federal Savings and Loan Association of St. Joseph* v. *United States,* 288 F. Supp. 477 (W.D. Mo. 1968), and in *Washington Federal Savings and Loan Association of Miami Beach* v. *United States,* 304 F. Supp. 1072 (S.D. Fla. 1969), we find extensive expositions of the applicable statutes and legislative history. Whatever may be said in favor of the proliferation of the printed legal word which has attended the effort of judicial draftsmen to make each opinion an integrated, comprehensive whole, in this situation, where we are concerned with unique and specialized statutory provisions having a tax impact only on one particular segment of the economy, the savings and loan institutions, we discern no advantage in repeating all the arguments, contentions and responses made by the parties here which have been thoroughly considered in the referenced opinions. Neither is it useful to restate the facts in detail, a statement which required twenty-three typewritten pages of the Tax Court opinion. We are writing with the assumption that the reader is familiar with the opinions to which reference has been made.

The taxpayer here is a state-chartered savings and loan association. The *St. Joseph* and *Miami Beach* opinions, *supra,* concerned federal savings and loan associations. The federal institutions are required by law to insure deposits with FSLIC and so to make the premium payments to the Secondary Reserve. A

state-chartered institution is not required by law to insure deposits with FSLIC. In this respect, the cases differ. The Tax Court, however, found as a fact that "in the opinion of its (taxpayer's) management loss of its insured status with the FSLIC would cause a mass withdrawal of savings by its depositors", and quite properly refused to distinguish the *St. Joseph* case on account of the difference we have noted. We deem both the *St. Joseph* and *Miami Beach* opinions to be persuasive authority in support of the contentions of this taxpayer and we adopt the cogent arguments in those opinions by reference, without repetition.

The Tax Court opinion approves Revenue Ruling 66-49 (Internal Revenue Bulletin, C.B. 1966-1, January-June 1966, p. 36). The headnote summarizes the ruling.[1] Such rulings, unlike Treasury Regulations, do not have the force of law and are at most merely

[1] "The additional premium prepayments which an insured savings and loan institution is required to pay to the Federal Savings and Loan Insurance Corporation under the provisions of section 404 of the National Housing Act, as amended, are not deductible when paid and may be deducted only when any possibility of their return is precluded. With respect to an accrual basis institution, earnings on such premiums are not includible in the gross income of that institution until such time as the earnings are no longer available for losses of the FSLIC. With respect to a cash basis institution, earnings on such premiums are includible in the gross income of the institution credited therewith only when such earnings are used to pay its obligations or become available to that institution without substantial restriction or limitation." Internal Revenue Bulletin, C.B. 1966-1, January-June 1966, p. 36.

persuasive.[2] We think the revenue ruling is wrong.

The question presented is whether the premium payments under 12 U.S.C. § 1727(d), which the taxpayer made into the Secondary Reserve of FSLIC, were deductible as "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." 26 U.S.C. § 162(a). The tax Court said no, and characterized the expense as a nondeductible capital expenditure. 26 U.S.C. § 262. In doing so, the Court emphasized the way the Secondary Reserve was accounted for and managed by FSLIC. It pointed out that Section 1727(d) payments "are not considered as income by the FSLIC"; are used "only for losses of the corporation * * * to such extent as other accounts * * * are insufficient"; that the Secondary Reserve account is "rather like a capital account"; that the Secondary Reserve is "part of a pool of capital available to the FSLIC * * * in the event of emergency. We think the emphasis upon the treatment of the receipt by the payee, FSLIC, is mistaken and that in determining whether an expense is an ordinary and necessary expense of doing business, the focus should be on the taxpayer and the taxpayer's business, not on what the payee does with the money paid. This is not to say that rights retained by the taxpayer are to be ignored.

---

[2] *Macey's Jewelry Corp.* v. *United States*, 387 F. 2d 70, 72 (5th Cir. 1967); *United States* v. *Bennett*, 186 F. 2d 407, 410 (5th Cir. 1951); cf. *Skidmore* v. *Swift & Co.*, 323 U.S. 134 (1944); *United States* v. *Jefferson Co. Bd. of Educ.*, 372 F. 2d 836, 858 (5th Cir. 1966); *Tandy Leather Co.* v. *United States*, 347 F. 2d 693 (5th Cir. 1965); *Norton Mfg. Corp.* v. *United States*, 288 F. Supp. 829, 835 (N.D. Ill. 1968); *Pauley* v. *United States*, 63 U.S.T.C. para. 9280 (S.D. Cal. 1963); *Kaiser* v. *United States*, 262 F. 2d 367, 370 (7th Cir. 1958), aff'd, 363 U.S. 299 (1960).

Obviously, the payment made to the Secondary Reserve has hybrid characteristics. If this were not so, there would be no lawsuit. The tax impact of the payment must depend upon whether it is more like a capital investment or a business expense.

In opting for the business expense treatment of this expenditure, we first consider whether the revenue ruling to the contrary is inconsistent with the annual accounting concept of income determination and income tax assessment. We think that it is. The importance of this concept was emphasized in *Security Mills Co.* v. *Comm'r,* 321 U.S. 281 (1944), where the Court said:

> "The rationale of the system is this: 'It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation.'
>
> "This legal principle has often been stated and applied. The uniform result has been denial both to Government and to taxpayer of the privilege of allocating income or outgo to a year other than the year of actual receipt or payment, or, applying the accrual basis, the year in which the right to receive, or the obligation to pay, has become final and definite in amount."

To treat the payments of premiums to the Secondary Reserve as the acquisition of a capital asset is a departure from the basic concept of accounting for receipts and disbursements in the year when made (on cash basis accounting). So, it is not just a matter of choosing one treatment or the other. On the contrary, persuasive reasons should appear to justify the departure.

The Commissioner's ruling also ignores another of the most fundamental concepts of federal income taxation. Both federal income taxation and generally accepted principles of the accounting profession assume that a corporate taxpayer is a "going concern" and will continue indefinitely. Ascertainment of revenue at the end of the accounting period does not hinge upon determination of liquidation value of closing inventories, nor is appreciation or depreciation in value of balance sheet assets considered. This concept is so basic that Congress felt compelled to provide a specific exemption for corporations formed or acquired primarily for liquidation. 26 U.S.C. § 341 (1964). Accordingly, to give consideration to the possibilities of reimbursement because of liquidation or receivership is inconsistent with this principle. The possibility of reimbursement by the taxpayer's voluntary act of termination of coverage is in the same category. The Tax Court found that Appellant's management believed that termination of insurance would cause mass withdrawal by its depositors and, ultimately liquidation. The Court also found that all but an insignificant portion of the savings and loan industry thought it necessary to have insurance coverage. Therefore, the practical realities require the conclusion that termination of coverage is not a proper consideration in determining the finality of the disbursement in issue. Termination here is deemed tantamount to liquidation or receivership.

We also believe that the revenue ruling is inconsistent within itself. It declares (1) that the payments to the Secondary Reserve were not deductible until any possibility of their return was precluded; also (2) that earnings on the Secondary Reserve are

taxable to the taxpayer only when they become available to it without substantial restriction or are paid out for its benefit. When we consider that under the "claim of right" doctrine, there must be an impossibility of even constructive possession to defeat taxation of income and that a non-contractual obligation of repayment will not defeat it (*James* v. *United States,* 366 U.S. 213 (1961)) in the context of the "all events" test fixing the accounting period for the allowance of deductions as the one in which all events had occurred which fixed the amount and the fact of the liability (*United States* v. *Anderson,* 269 U.S. 422 (1926); *Dixie Pine Co.* v. *Comm.,* 320 U.S. 516 (1944); *United States* v. *Consolidated Edison Co.,* 366 U.S. 380 (1961)), there is an incongruity in a ruling that the income credited to the Secondary Reserve allocated to the taxpayer was not then taxable because of the restrictions on its use, while at the same time these same restrictions precluded deduction of the premium payments as business expenses. If there were so many restrictions on the funds paid to FSLIC that the income derived therefrom was not even constructively received and was not taxable when credited, *a fortiori* these same restrictions on reimbursement or recapture of the funds made the payment final and deductible in the year it was made. All events had occurred which fixed the amount and the fact of the liability.

From the point of view of Congressional policy, we should observe that the rule of *United States* v. *Consolidated Edison Co.,* 366 U.S. 380 (1961), holding that a contested tax liability paid under protest could be deducted not in the year of payment but only in the year liability became fixed and final has been reversed

by Congress. 26 U.S.C. § 461(f).[3] The Senate Report, in explanation of the 1964 amendment, states, in part: "The objective of the reporting of items of income and deduction under the internal revenue laws generally is to realistically and practically match receipts and disbursements attributable to specific taxable years. The internal revenue laws contain a number of adjustments designed to accomplish this result. Your committee believes that allowing the deduction of items in the year paid, even though they are still being contested in the courts or otherwise, more realistically matches these deductions up with the income to which they relate than would the postponement of the deduction, perhaps for several years, until the contest is settled." U.S. Cong. & Adm. News, 88th Cong., 2nd Sess., p. 1773.

This reaffirmation of basic Congressional policy obviously is not specific authority for our particular problem. It, nevertheless, should incline us to recognizing deductions in the year payment is made rather than to postpone them because of contingent and sometimes quite illusory possibilities of recapture.

The payments made by this taxpayer into the Secondary Reserve of FSLIC meet the tests of necessary business expenses. The expense is "appropriate and helpful" for the "development of the taxpayer's busi-

[3] "(f) Contested liabilities.—If—

"(1) the taxpayer contests an asserted liability,

"(2) the taxpayer transfers money or other property to provide for the satisfaction of the asserted liability,

"(3) the contest with respect to the asserted liability exists after the time of the transfer, and

"(4) but for the fact that the asserted liability is contested, a deduction would be allowed for the taxable year of the transfer (or for an earlier taxable year),

"then the deduction shall be allowed for the taxable year of the transfer." 26 U.S.C. § 461(f).

ness." *Commissioner* v. *Tellier,* 383 U.S. 687 (1966). To say that they are also "ordinary" is to beg the question which faces us inasmuch as "ordinary" is a qualification designed to exclude expenditures "in the nature of capital expenditures which, if deductible at all, must be amortized over the useful life of the asset." *Commissioner* v. *Tellier, supra.* These payments, nevertheless, fulfill our conception of an "ordinary" business expense. It is a recurring annual expense geared primarily to acceleration of the taxpayer's business; that is, the increase in the accounts of the insured members. It is an expense which, from a practical point of view, has to be paid to stay in business. It must be paid regardless of whether income is available for the purpose. The obligation is not associated with an increase of the taxpayer's income. On the contrary, it is generated because of an increase in the taxpayer's liabilities. When these identifying brands are present, it is practical and essential that the character of the expenditure as an ordinary, as well as necessary, business expense be recognized. Otherwise, the impact of the tax may destroy the business.

For the reasons stated, in addition to those articulated in the *St. Joseph* and *Miami Beach* cases, *supra,* we deem Revenue Ruling 66–49 to be unreasonable. The decision of the Tax Court is reversed.

HUFSTEDLER, *Circuit Judge:*

I respectively dissent. There is nothing in the record to support the majority's statement that the payments are a "recurring annual expense." To the contrary, the Tax Court found that in all likelihood the section 1727(d) payments would be required for a duration of only a few years (until approximately 1971) and that thereafter the suspension provisions of 1727(g) would be in effect. The taxpayer's pro rata share of the Sec-

ondary Reserve would then be used to discharge its premium obligations under section 1727(b). "[F]or all practical purposes, [the section 1727(d)] payments will definitely be used to discharge the obligation of the insured institution to pay regular annual premiums in future years, assuming it has not previously transferred its pro rata share of the Secondary Reserve or received a cash payment in respect thereof from the FSLIC." (51 T.C. at 102).

For this and the other reasons expressed by the unanimous Tax Court, I would affirm on the ground that the payments are "in the nature of a prepayment with respect to future premiums," and are not therefore deductible as an ordinary and necessary business expense in the year made.

APPENDIX C

United States Court of Appeals for the Ninth Circuit

No. 23923 (Tax Ct No. 325–68)

LINCOLN SAVINGS AND LOAN ASSOCIATION, APPELLANT

v.

COMMISSIONER OF INTERNAL REVENUE, APPELLEE

Upon Petition to Review a Decision of The Tax Court of the United States

(Filed and entered Feb. 3, 1970)

JUDGMENT

This Cause came on to be heard on the Transcript of the Record from The Tax Court of the United States and was duly submitted.

On Consideration Whereof, it is now here ordered and adjudged by this Court, that the Decision of the said Tax Court of the United States in this Cause be, and hereby is reversed.

APPENDIX D

United States Court of Appeals for the Ninth Circuit

Excerpt from Proceedings of Wednesday,

March 18th, 1970

Order Denying Petition for Rehearing

Before: ELY and HUFSTEDLER, *Circuit Judges,* and THOMPSON, *District Judge.*

On consideration thereof, and by direction of the Court, *It is ordered* that the petition of appellee filed February 20, 1970 and within time allowed therefor by rule of court, for a rehearing of above cause be, and hereby is denied, and rejecting suggestion for rehearing en banc.

APPENDIX E

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) *In General.*—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *.

* * * * *

Treasury Regulations on Income Tax (~~26 C.F.R.~~):

§ 1.461–1. *General rule for taxable year of deduction.*

(a) *General rule*—(1) *Taxpayer using cash receipts and disbursements method.* Under the cash receipts and disbursements method of accounting, amounts representing allowable deductions shall, as a general rule, be taken into account for the taxable year in which paid. Further, a taxpayer using this method may also be entitled to certain deductions in the computation of taxable income which do not involve cash disbursements during the taxable year, such as the deductions for depreciation, depletion, and losses under sections 167, 611, and 165, respectively. If an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may deductible only in part,

for the taxable year in which made. An example is an expenditure for the construction of improvements by the lessee on leased property where the estimated life of the improvements is in excess of the remaining period of the lease. In such a case, in lieu of the allowance for depreciation provided by section 167, the basis shall be amortized ratably over the remaining period of the lease. See section 178 and the regulations thereunder for rules governing the effect to be given renewal options in determining whether the useful life of the improvements exceeds the remaining term of the lease where a lessee begins improvements on leased property after July 28, 1958, other than improvements which on such date and at all times thereafter, the lessee was under a binding legal obligation to make. See section 263 and the regulations thereunder for rules relating to capital expenditures.

(2) *Taxpayer using an accrual method.* Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy. However, any expenditure which results in the creation of an asset having a useful life which

extends substantially beyond the close of the taxable year may not be deductible, or may be deductible only in part, for the taxable year in which incurred. While no accrual shall be made in any case in which all of the events have not occurred which fix the liability, the fact that the exact amount of the liability which has been incurred cannot be determined will not prevent the accrual within the taxable year of such part thereof as can be computed with reasonable accuracy. For example, A renders services to B during the taxable year for which A claims $10,000. B admits the liability to A for $5,000 but contests the remainder. B may accrue only $5,000 as an expense for the taxable year in which the services were rendered. In the case of certain contested liabilities in respect of which a taxpayer transfers money or other property to provide for the satisfaction of the contested liability, see § 1.461–2. Where a deduction is properly accrued on the basis of a computation made with reasonable accuracy and the exact amount is subsequently determined in a later taxable year, the difference, if any, between such amounts shall be taken into account for the later taxable year in which such determination is made.

* * * * *

400-943—70——6

APPENDIX F

Federal Home Loan Bank Act, c. 522, 47 Stat. 727:

SEC. 6. [as amended by Sec. 509 of the National Housing Act, c. 847, 48 Stat. 1264, and Sec. 2 of the Act of June 27, 1950, c. 369, 64 Stat. 257, 12 U.S.C. (1958 ed.) 1426].

* * * * *

(c) The original stock subscription for each institution eligible to become a member under section 4 shall be an amount equal to 1 per centum of the aggregate of the unpaid principal of the subscriber's home mortgage loans, but not less than $500. The board shall from time to time adjust the amount of stock held by each member to that, as nearly as possible, such member shall at all times have invested in the stock of the Federal Home Loan Bank at least an amount calculated in the manner provided in the preceding sentence (but not less than $500). If the board finds that the investment of any member in stock is greater than that required under this section, upon application of such member, the bank shall pay such member for each share of stock in excess of the amount so required an amount equal to the value of such stock, or, at the election of the bank, the whole or any part of the payments which would be so made shall be credited upon the indebtedness of the member to the bank. In either such event, stock equal in value to the amount of the payment or credit, or both, as the case may be, shall be surrendered and canceled. No share of stock shall be surrendered and canceled if the effect of such surrender and cancellation would be to violate the provisions of section 10(c) requiring the amount of stock held by such member to equal at least one-twelfth of the outstanding advances to such member.

* * * * *

(l) Within one year after the enactment of this subsection, each member of each Federal Home Loan Bank shall acquire and hold and thereafter maintain its stockholding in an amount equal to at least 2 per centum of the aggregate of the unpaid principal of such member's home mortgage loans, home-purchase contracts, and similar obligations, but not less than $500. Such stock in excess of the amount hereby required may be purchased from time to time by members and may be retired from time to time as heretofore. One year after the enactment of this subsection, each Federal Home Loan Bank shall retire and pay off at par an amount of its stock held by the Secretary of the Treasury equivalent to the amount of its stock held by its members in excess of the amount required to be held by them by the first two sentences of subsection (c) of this section immediately prior to the enactment of this subsection and annually thereafter each Federal Home Loan Bank shall retire an amount of such Government stock equivalent to 50 per centum of the net increase of its stock held by members since the last previous retirement: *Provided,* That none of such Government capital shall at any time be retired so as to reduce the aggregate capital stock, reserves, surplus, and undivided profits of the Federal Home Loan Banks to less than $200,000,000: *Provided further,* That notwithstanding any provision of this subsection, nothing in this subsection shall limit or affect the operation of subsection (g) of this section.

National Housing Act, c. 847, 48 Stat. 1246:

SEC. 404 [as amended by Sec. 25, Act of May 28, 1935, c. 150, 49 Stat. 298, and Sec. 7 of the Act of June 27, 1950, 64 Stat. 259, 12 U.S.C. 1958 ed.) 1727].

(a) Each institution whose application for insurance is approved by the Corporation shall

pay to the Corporation, in such manner as it shall prescribe, a premium charge for such insurance equal to one-twelfth of 1 per centum of the total amount of all accounts of the insured members of such institution plus any creditor obligations of such institution. Such premium shall be paid at the time the certificate is issued by the Corporation under section 403, and thereafter annually until a reserve fund has been established by the Corporation equal to 5 per centum of all insured accounts and creditor obligations of all insured institutions; except that under regulations prescribed by the Corporation such premium charge may be paid semiannually. If at any time such reserve fund falls below such 5 per centum, the payment of such annual premium charge for insurance shall be resumed and shall be continued until the reserve is brought back to such 5 per centum. For the purposes of this subsection, the amount in all accounts of insured members and the amount of creditor obligations of any institution may be determined from adjusted statements made within one year prior to the approval of the application of such institution for insurance, or in such other manner as the Corporation may by rules and regulations prescribe.

(b) The Corporation is further authorized to assess against each insured institution additional premiums for insurance until the amount of such premiums equals the amount of all losses and expenses of the Corporation; except that the total amount so assessed in any one year against any such institution shall not exceed one-eighth of 1 per centum of the total amount of the accounts of its insured members and its creditor obligations.

* * * * *

APPENDIX G

Federal Home Loan Bank Act, c. 522, 47 Stat. 727:

SEC. F. [as amended by Sec. 1 of the Act of September 8, 1961, P.L. 87-210, 75 Stat. 482, 12 U.S.C. 1426].

* * * * *

(c)(1) The original stock subscription of each institution eligible to become a member under section 4 shall be an amount equal to 1 per centum of the subscriber's aggregate unpaid loan principal, but not less than $500. The bank shall annually, as of the close of the calendar year, adjust, at such time and in such manner and upon such terms and conditions as the Federal Home Loan Bank Board may by regulations or otherwise prescribe, the amount of stock held by each member so that such member shall have invested in the stock of the Federal Home Loan Bank at least an amount calculated in the manner provided in the next preceding sentence (but not less than $500). If the bank finds that the investment of any member in stock is greater than that required under this subsection it may, unless prohibited by said Board or by the provisions of paragraph (2) of this subsection, in its discretion and upon application of such member retire the stock of such member in excess of the amount so required. Said Board, in its discretion, may, by regulations or otherwise, provide for adjustments in amounts of stock to be issued or retired in order that stock may be issued or retired only in entire shares.

* * * * *

National Housing Act, c. 847, 48 Stat. 1246:

SEC. 402. [as amended by Sec. 6 of the Act of June 27, 1950, c. 369, 64 Stat. 259, 12 U.S.C. 1725].

* * * * *

(i) The Corporation is authorized to borrow from the Treasury, and the Secretary of the Treasury is authorized and directed to loan to the Corporation on such terms as may be fixed by the Corporation and the Secretary, such funds as in the judgment of the Home Loan Bank Board are from time to time required for insurance purposes, not exceeding in the aggregate $750,000,000 outstanding at any one time, and the Corporation hereafter shall not exercise its borrowing power under the first sentence of subsection (d) of this section for the purpose of borrowing money from any other source: *Provided,* That each such loan shall bear interest at a rate determined by the Secretary of the Treasury, taking into consideration the current average rate on outstanding marketable obligations of the United States as of the last day of the month preceding the making of such loan: *Provided further,* That nothing in this subsection shall prevent the Corporation from issuing debentures in accordance with the provisions of subsection (b) of section 405. For the purposes of this subsection the Secretary of the Treasury is authorized to use as a public-debt transaction the proceeds of the sale of any securities hereafter issued under the Second Liberty Bond Act, as now or hereafter in force, and the purposes for which securities may be issued under the Second Liberty Bond Act, as now or hereafter in force, are hereby extended to include such loans. Any such loan shall be used by the Corporation solely in carrying out its functions with respect to such insurance. All loans and repayments under this subsection shall be treated as public-debt transactions of the United States.

SEC. 404. [as amended by Secs. 3, 4, 5, and 6 of the Act of September 8, 1961, *supra*, 12 U.S.C. 1727].

(a) The Corporation shall establish a Primary Reserve which shall be the general re-

serve of the Corporation and a Secondary Reserve to which shall be credited the amounts of the prepayments made by insured institutions pursuant to subsection (d) and the credits made pursuant to the first sentence of subsection (e).

(b)(1) Each institution whose application for insurance is approved by the Corporation shall pay to the Corporation, in such manner as it shall prescribe, a premium for such insurance equal to one-twelfth of 1 per centum of the total amount of all accounts of the insured members of such institution plus any creditor obligations of such institution. Such premium shall be paid at the time the certificate is issued by the Corporation under section 403, and thereafter annually, except that under regulations prescribed by the Corporation such premium may be paid semiannually.

(2) If, at the close of any December 31, the Primary Reserve equals or exceeds 2 per centum of the total amount of all accounts of insured members and creditor obligations of all insured institutions as of such close, no premium under paragraph (1) of this subsection shall be payable by any insured institution with respect to its premium year beginning during the year commencing on May 1 next succeeding such December 31, except that the foregoing provisions of this sentence shall not be applicable to any insured institution with respect to any of the twenty premium years beginning with the premium year commencing with the date on which such certificate is issued.

(3) The Corporation is authorized to prescribe such rules and regulations as it may determine to be necessary or appropriate to accomplish the purposes and provisions of this subsection.

(c) The Corporation is further authorized to assess against each insured institution additional premiums for insurance until the amount of such premiums equals the amount of all losses and expenses of the Corporation; except

that the total amount so assessed in any one year against any such institution shall not exceed one-eighth of 1 per centum of the total amount of the accounts of its insured members and its creditor obligations.

(d) Each insured institution, except as otherwise provided in this section, shall annually pay to the Corporation, at such time and in such manner as the Corporation shall by regulations or otherwise prescribe, an additional premium in the nature of a prepayment with respect to future premiums of such institution under subsection (b) equal to 2 per centum of the net increase in all accounts of its insured members during the next preceding calendar year, less an amount equal to any requirement, as of the end of such calendar year, for the purchase of stock of the Federal Home Loan Bank of which such institution is a member, calculated in accordance with the provisions of subsection (c) of section 6 of the Federal Home Loan Bank Act and without regard to any net increase during such calendar year in its holdings of such stock, and such prepayments shall be credited to the Secondary Reserve: *Provided*, That in the case of an insured institution which was not an insured institution at the beginning of such next preceding calendar year the 2 per centum aforesaid shall be 2 per centum of the net increase in all accounts of its insured members during that part of said calendar year which begins with the close of the day on which such institution becomes an insured institution and the amount deducted from such 2 per centum under the foregoing provisions of this sentence shall not exceed one-half of such 2 per centum as calculated in accordance with this proviso. The Federal Home Loan Bank Board shall by regulations or otherwise provide for the furnishing to the Corporation of all necessary information with respect to Federal Home Loan Bank stock.

(e) The Corporation, in accordance with such regulations as it may prescribe, shall credit to the Secondary Reserve, as of the close of each calendar year a return on the outstanding balances of the Secondary Reserve during such calendar year, as determined by the Corporation, at a rate equal to the average annual rate of return to the Corporation during the year ending at the close of November 30 of such calendar year, as determined by the Corporation, on the investments held by the Corporation in obligations of, or guaranteed as to principal and interest by, the United States. Except as provided in subsections (f) and (g), the Secondary Reserve shall be available to the Corporation only for losses of the Corporation and shall be so available only to such extent as other accounts of the Corporation which are available therefor are insufficient for such losses. No right, title, or interest of any institution in or with respect to its pro rata share of the Secondary Reserve shall be assignable or transferable, whether by operation of law or otherwise, except to such extent as the Corporation may by regulation or otherwise provide for transfer of such pro rata share in cases of merger or consolidation, transfer of bulk assets as defined by the Corporation by regulation or otherwise for the purposes of this sentence, and similar transactions as so defined.

(f) If (i) the status of an insured institution as an insured institution is terminated pursuant to any provision of section 407 or the insurance of accounts of an insured institution is otherwise terminated, (ii) a conservator, receiver, or other legal custodian is appointed for an insured institution under the circumstances and for the purpose set forth in subdivision (d) of section 401, or (iii) the Corporation makes a determination that for the purposes of this subsection an insured institution has gone into liquidation, the obligation of such institution to

make prepayments under subsection (d) of this section, including any prepayments as to which such institution is obligated at the time of such termination, appointment, or determination, shall cease, and the Corporation shall pay in cash to such institution its pro rata share of the Secondary Reserve, in accordance with such terms and conditions as the Corporation may prescribe by regulations or otherwise, or, at the option of the Corporation, the Corporation may apply the whole or any part of the amount which would otherwise be paid in cash toward the payment of any indebtedness or obligation, whether matured or not, of such institution to the Corporation, then existing or arising before such payment in cash: *Provided,* That such payment or such application need not be made to the extent that the provisions of the exception in the last sentence of subsection (e) are applicable. The Corporation in its discretion may provide by regulations or otherwise for the reinstatement in whole or in part, upon such terms and conditions as to payment or otherwise as it may prescribe, of the pro rata share of an institution in the Secondary Reserve in the event that such status or such insurance is restored by action of the Corporation or of a court in reversing or setting aside such termination, or in the event that, after such appointment or such determination, an institution is restored to operation as an insured institution, and for the payment, waiver, or other treatment in whole or in part of any prepayments which, in the absence of the first sentence of this subsection, would have accrued under subsection (d) or would be payable thereunder.

(g) If, at the close of any December 31, the aggregate of the Primary Reserve and the Secondary Reserve equals or exceeds 2 per centum of the total amount of all accounts of insured members and creditor obligations of all insured institutions but the Primary Reserve does not equal or exceed such 2 per centum, no insured institution shall be obligated to make any prepayment under subsection (d) during the year beginning with May 1 next succeeding such close, and each insured institution's pro rata share of the Secondary Reserve shall be used, to the extent available, to discharge such institution's obligation for its premium under subsection (b) for the premium year beginning in such year; and the suspension of obligation to make such prepayments and the use of such pro rata shares as provided in this sentence shall continue unless and until the next sentence or the last sentence of this subsection shall become operative. If, at the close of any December 31 occurring before the last sentence of this subsection shall become operative, the aggregate of the Primary Reserve and the Secondary Reserve is not at least equal to 1¾ per centum of the total amount of all accounts of insured members and creditor obligations of all insured institutions, (i) the obligation of insured institutions to make prepayments under subsection (d) shall resume on May 1 next following such December 31 and shall continue unless and until the first sentence or the last sentence of this subsection shall become operative, and (ii) the use of any insured institution's pro rata share of the Secondary Reserve under the first sentence of this

subsection shall terminate with respect to its premium under subsection (b) for the premium year beginning during the calendar year commencing on May 1 next succeeding such December 31, and such termination shall continue unless and until the first sentence of this subsection shall become operative. If, at the close of any December 31, the Primary Reserve equals or exceeds such 2 per centum, the Corporation shall, at such time (which shall be the same for all insured institutions and shall not be later than May 1 next succeeding such close) and in such manner as the Corporation shall determine, pay in cash to each insured institution its pro rata share of the Secondary Reserve and shall not, after such time, accept or receive further prepayments under subsection (d).

U.S. GOVERNMENT PRINTING OFFICE: 1970